APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT DECIDED AND FILED APRIL 28, 2003

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 01-3495

AMERICAN ELECTRIC POWER COMPANY, INC. et al.,

Plaintiffs-Appellants,

v.

UNITED STATES OF AMERICA,

Defendant-Appellee.

Appeal from the United States District Court
for the Southern District of Ohio at Columbus.
Nos. 98-00304; 99-00724—James L. Graham,
District Judge.

Argued: March 11, 2003

Decided and Filed: April 28, 2003

Before: NELSON, COLE, and GILMAN, Circuit Judges.

OPINION

RONALD LEE GILMAN, Circuit Judge. American Electric Power Company, Inc. (AEP) implemented a corporate-owned life insurance (COLI) plan in 1990 that

caused it to purchase policies on the lives of over 20,000 of its employees. In 1996, AEP deducted from its federal income tax approximately $66 million in interest due on loans made against the policies. The IRS disallowed the deduction and assessed AEP with an additional $25 million in taxes for the year in question. AEP paid the additional tax under protest and then sued for a refund in federal district court. After a six-week bench trial, the district court granted judgment in favor of the government. For the reasons set forth below, we **AFFIRM** the judgment of the district court.

I. BACKGROUND

A. Factual background

AEP purchased a COLI plan offered by Mutual Benefit Life Insurance Company (MBL) in 1990. (By virtue of a reinsurance transaction, Hartford Life Insurance Company replaced MBL as the primary insurer in 1993. For simplicity, both companies will hereafter be referred to as MBL.) The plan consisted of life insurance policies on over 20,000 AEP employees. AEP was the named beneficiary on all of these policies. Each policy had a fixed annual premium of $16,667, the significance of which is explained in Part II.A. below.

The plan utilized an intricate funding mechanism. On the first day of each of the first three policy years, two financial transfers took place simultaneously. The first was the total premium paid by AEP (an amount in excess of $330 million), which MBL credited to the "policy value." ("Policy value" is a term of art utilized by the parties to denote the cumulative gross value of all the insurance policies within

the COLI plan.) The other was a loan extended to AEP by MBL, with the policy value used as collateral, in an amount equal to more than 90 percent of the gross premium. In the first year, for example, this "netting transaction" resulted in AEP actually paying MBL the greatly reduced sum of $23.5 million.

A different netting transaction occurred on the first day of each of the next four policy years. AEP paid the full premium, but MBL applied only about 5 percent of the premium to increase the policy value. It took the remainder as an "expense charge." MBL then returned to AEP approximately 95 percent of the amount taken as an expense charge as a "loading dividend." AEP also paid the accrued loan interest, but withdrew from the policy value nearly the same amount. Thus, as in years one through three, the cash actually paid by AEP to MBL in years four through seven was only a small percentage of the stated cost of the premiums.

The net equity of AEP's COLI plan was based upon the policy value, minus policy loans and accrued interest. AEP's plan operated so that whatever cash was paid in at the beginning of the year was used up by the year's end. At the end of each year, therefore, the COLI plan had a net equity of zero.

The plan was also designed to ensure "mortality neutrality." This meant that neither AEP nor MBL reasonably expected to profit over the life of the plan because of the death of AEP employees. To achieve this equilibrium, "cost-of-insurance charges" increased if more employees died

than were expected, and, if experience proved the opposite, the insurance company paid AEP "mortality dividends."

The COLI plan afforded AEP the opportunity to annually select from a menu of options the interest rate that it would pay MBL on the policy loans. AEP always picked one of the highest interest-rate choices, never the lowest. For example, the policy-loan interest rate chosen for the first year was 11.88 percent, even though AEP could have selected a rate as low as 7.4 percent. AEP had two incentives to choose the higher rates: (1) the higher rates increased its tax deduction for interest paid, and (2) the COLI plan provided that the true cost to AEP was only the one-percent differential between what AEP paid MBL as interest on the policy loans and what MBL credited back to AEP in the form of "interest" on the policy value.

The interest-rate component of AEP's COLI plan was only one of many provisions designed to exploit certain aspects of the Internal Revenue Code (IRC) then in effect, which are discussed in Part II.A. below. AEP fully understood that the plan would generate positive cash flow in every policy year only if it could deduct from its income taxes the interest on the policy loans. It decided to implement the COLI plan based upon this expectation. In 1996, however, the IRS refused to allow the claimed deduction. AEP therefore paid the additional tax under protest and then instituted this action to recover its alleged overpayment.

B. Procedural background

A bench trial commenced in October of 2000 and concluded two months later. Both sides filed proposed findings of fact and post-trial memoranda. In February of 2001, the district court granted judgment in favor of the United States. The court determined that the COLI plan was an economic sham. It also held that the dividends in the fourth through seventh years of the plan, among other aspects, were shams in fact. This timely appeal followed.

II. ANALYSIS

A. Whether the COLI plan was an economic sham

Generally, a taxpayer may deduct "all interest paid or accrued within the taxable year on indebtedness." IRC § 163(a). But special rules apply to life insurance. In 1990, IRC § 264(a)(3) provided that, with certain exceptions, no deduction was permitted for "any amount paid or accrued on indebtedness incurred or continued to purchase or carry life insurance . . . pursuant to a plan of purchase which contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of such contract. . . ." Section 264(c)(1) delineated the exception relevant to AEP's COLI plan: a deduction was allowed "if no part of 4 of the annual premiums due during the 7-year period (beginning with the date the first premium on the contract to which such plan relates was paid) is paid under such plan by means of indebtedness." In any case, § 264(a)(4) capped the interest that could be deducted on indebtedness incurred to purchase life insurance at $50,000 of indebtedness per insured life.

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AEP's COLI plan on its face fits neatly within the 4-of-7 safe harbor rule. Only in the first three years of the plan were premiums financed through policy loans. And because the premiums were fixed at $16,667, the policy loans through the first three years were precisely matched to the $50,000 of indebtedness per insured life on which the interest was deductible ($16,667 x 3 years = $50,001).

But when "it is patent that there [is] nothing of substance to be realized by [the taxpayer] from [a] transaction beyond a tax deduction," the deduction is not allowed despite the transaction's formal compliance with Code provisions. *Knetsch v. United States*, 364 U.S. 361, 366 (1960) (holding that the purchase of several annuity bonds was substantively a sham, and should therefore be disregarded in determining the validity of claimed income tax deductions, where the premiums were paid by loans secured by the bonds and additional borrowing reduced the annuity each bond would pay from tens of thousands to a pittance). This is known as the economic sham, or sham-in-substance, doctrine. In this circuit,

> [t]he proper standard in determining if a transaction is a sham is whether the transaction has any practicable economic effects other than the creation of income tax losses. A taxpayer's subjective business purpose and the transaction's objective economic substance may be relevant to this inquiry.

Rose v. Comm'r, 868 F.2d 851, 853 (6th Cir. 1989) (citations omitted).

Appendix A

The district court decided that AEP's COLI plan was an economic sham. Its findings of fact on this issue are reviewed under the "clearly erroneous" standard. *Rink v. Comm'r*, 47 F.3d 168, 172 (6th Cir. 1995). But the standard of review for the ultimate conclusion—sham or no sham—is not as clear. The government asserts that the ultimate conclusion is also subject to the clearly erroneous standard of review, citing *Ratliff v. Commissioner*, 865 F.2d 97, 98 (6th Cir. 1989) (stating that "[t]here is one issue presented in this case: whether the Tax Court erred in concluding that the straddle transactions engaged in by the taxpayers were 'shams in substance,' " and then asserting that "the determination of the Tax Court is binding on the appellate court unless clearly erroneous").

This court, however, has subsequently read *Ratliff* as meaning that "the legal standard applied by the Tax Court and its legal conclusions based upon its findings of fact are reviewed *de novo*." *Smith v. Comm'r*, 937 F.2d 1089, 1096 (6th Cir. 1991) (citing *Ratliff*, 865 F.2d at 98). Relying on *Smith*, AEP contends that de novo review of the district court's ultimate determination is appropriate. Beyond their arguments and the above citations, the parties do not provide any additional guidance concerning the proper standard of review.

Smith does seem to adopt a strained reading of *Ratliff*, and "[a] panel of this [c]ourt cannot overrule the decision of another panel," *Salmi v. Sec'y of Health & Human Servs.*, 774 F.2d 685, 689 (6th Cir. 1985). But the standard of review announced in *Smith* is clearly correct, given that the Supreme Court has stated that "[t]he general characterization of a

transaction for tax purposes is a question of law. . . ." *Frank Lyon Co. v. United States*, 435 U.S. 561, 581 n.16 (1978). Because *Ratliff* did not specifically hold that the ultimate question of whether a transaction is a sham is to be reviewed under the clearly erroneous standard (although one of its parenthetical citations did so state), and because *Frank Lyon* indicates that review should be de novo, we will follow *Smith*. The district court's conclusion that AEP's COLI plan was a sham is therefore subject to de novo review.

We now turn to the merits of the case. "The main nontax benefits insurance plans generally offer are mortality gains to the beneficiary, who does not pay tax on proceeds, and interest-free inside build-up [the accrual of interest on the policy value]." *In re CM Holdings*, 301 F.3d 96, 103 (3d Cir. 2002). AEP was unable to realize either benefit on its COLI plan, however, because the plan was mortality-neutral and had zero net equity at the end of each policy year.

The district court found that, absent the policy-loan interest deductions, AEP would lose a substantial amount of money on its COLI plan; but with the deductions, AEP stood to gain positive cash flow every year. *Am. Elec. Power Inc. v. United States*, 136 F.Supp.2d 762, 787 (S.D. Ohio 2001). Moreover, the district court found that "the opportunity for tax arbitrage . . . was the real motivation for AEP's purchase of the COLI policies." *Id.* at 786. The COLI plan thus bears the hallmarks of an economic sham.

AEP contends, however, that *Woodson-Tenent Laboratories, Inc. v. United States*, 454 F.2d 637 (6th Cir. 1972), dictates a contrary conclusion. We disagree. This court in

Woodson-Tenent found that the two corporate-owned life insurance policies on key employees had economic substance. Under those policies, the company could have realized a substantial mortality gain if its key employees died prematurely. In contrast, the mortality-neutral design of AEP's COLI plan eliminated this possibility. *Woodson-Tenent* is therefore inapposite.

AEP also relies upon *United States v. Consumer Life Insurance Co.*, 430 U.S. 725 (1977). In *Consumer Life*, the Supreme Court held that a reinsurance agreement between two insurance companies, which included a provision that the reinsurer would eventually recoup the amount it paid out on claims through "experience refunds" from the primary insurer, had economic substance. *Id.* at 737-38. We agree, but simply find a world of difference between having a "mortality neutrality" provision or its equivalent in a reinsurance agreement between two insurance companies as opposed to having such a provision in an agreement between an insurance company and the insured. Mortality gains to the beneficiary, after all, are one of the main nontax benefits, if not *the* main nontax benefit, that motivates consumers to purchase life insurance policies. *In re CM Holdings*, 301 F.3d at 103. We therefore find AEP's reliance on *Consumer Life* unpersuasive.

Similar reasoning leads us to reject AEP's argument that because "each individual COLI policy transfers risk and has economic substance," the COLI plan as a whole must have economic substance. Each individual COLI policy did in fact transfer risk and thereby have economic substance, as was the case in *Woodson-Tenent*. Mortality neutrality, however,

operated on the plan as a whole, ensuring that whatever transfer of risk occurred at the level of the individual policy ceased to exist for the overall plan.

AEP alternatively contends that the plan had nontax economic consequences because some of its subsidiaries experienced mortality loss, while others experienced mortality gain. This argument suffers from the same flaw. The economic-sham analysis focuses on the "substance to be realized by [the taxpayer] from [a] *transaction*," *Knetsch*, 364 U.S. at 366 (emphasis added), and the transaction here was AEP's purchase of the COLI plan. Mortality neutrality and zero net equity operated only at the level of the entire plan. AEP cites *Humana Inc. v. Commissioner*, 881 F.2d 247 (6th Cir. 1989), for the proposition that "differing subsidiary-level experience means the transaction has economic effect." But *Humana* is readily distinguishable, partly because of the completely different fact pattern where both the insured and the insurer were wholly owned subsidiaries of the same parent corporation, and partly because the policies at issue in *Humana* were not mortality-neutral. The case simply has no relevance to the factual circumstances before us.

Another case upon which AEP relies, *Sacks v. Commissioner*, 69 F.3d 982 (9th Cir. 1995), is also easily distinguishable. The court in *Sacks* reasoned as follows:

> Factors which demonstrate that Mr. Sacks' deal had genuine economic effects, and was not a sham, are that (1) Mr. Sacks' personal obligation to pay the price was genuine; (2) he paid fair market value; (3) the tax benefits would have existed for

> someone, either BFS Solar or Mr. Sacks, so the transaction shifted them but did not create them from thin air; (4) the business of putting solar water heaters on homeowners' roofs was genuine; and (5) the business consequences of a rise or fall in energy prices and solar energy devices were genuinely shifted to Sacks by the transaction.

Id. at 988. In contrast, AEP did nothing more than "show[ ] a deductible expense on paper, without actually suffering any of the ordinary economic consequences of paying the money," *id.*, because circular netting transactions obviated the obligation to ever actually repay the underlying policy loans. This means that the tax benefits generated by the circular policy-loan interest deductions arose "from thin air." *Id.* Furthermore, the business consequences of unanticipated mortality experience were not genuinely assumed by either AEP or MBL because the plan was mortality-neutral.

AEP therefore has no basis to rely on the dictum in *Sacks* that "[w]here a transaction has economic substance, it does not become a sham merely because it is likely to be unprofitable on a pre-tax basis." *Id.* at 991. As the foregoing analysis demonstrates, Sacks's transaction had genuine economic consequences other than the creation of deductions, whereas AEP's does not.

Nor do we believe that the *Sacks* court's dictum about "pre-tax" profitability means, as AEP urges, that we should evaluate the transaction's profitability *after* the challenged deduction has been allowed. To do so would swallow the sham analysis entirely. As the Third Circuit has explained:

> The point of the analysis is to remove from consideration the challenged tax deduction, and evaluate the transaction on its merits, to see if it makes sense economically or is mere tax arbitrage. Courts use 'pre-tax' as shorthand for this, but they do not imply that the court must imagine a world without taxes, and evaluate the transaction accordingly. Instead, they focus on the abuse of the deductions claimed. . . . Choosing a tax-favored investment vehicle is fine, but engaging in an empty transaction that shuffles payments for the sole purpose of generating a deduction is not.

In re CM Holdings, 301 F.3d 96, 105 (3d Cir. 2002). Life insurance is tax-favored, and a company may utilize the tax advantages of a COLI plan so long as the plan has real economic consequences. Such was the case in *Woodson-Tenent.* But it may not utilize life insurance solely to create tax deductions, as was done in the present case, and expect those deductions to be allowed.

AEP's final argument as to why the COLI plan was not a sham is based on AEP's good faith intent to utilize the tax savings from the plan to offset dramatically increased costs due to a mandated accounting change regarding its employees' medical benefits, rather than having to cover the cost increase with higher utility rates to its customers. The controlling question, however, is whether there is anything of "substance to be realized by [the taxpayer] from [a] transaction beyond a tax deduction." *Knetsch*, 364 U.S. at 366.

In stating that "[a] taxpayer's subjective purpose . . . may be relevant to this inquiry," *Rose v. Comm'r*, 868 F.2d 851, 853 (6th Cir. 1989), this court was referring to the taxpayer's subjective intent with respect *to the transaction itself*, not its intent with respect to potential uses for the tax savings to be derived from a sham transaction. *Illes v. Comm'r*, 982 F.2d 163, 166 (6th Cir. 1992) (quoting the above statement by the *Rose* court and explaining that the economic-sham inquiry "consists of an examination of the transaction, not the taxpayer. If the transaction lacks economic substance, then the deduction must be disallowed without regard to the 'niceties' of the taxpayer's intent."). Money generated by means of abusive tax deductions can always be applied to beneficial causes, but the eventual use of the money thus generated is not part of the economic-sham analysis. *In re CM Holdings*, 254 B.R. 578, 638-39 (2000).

Both the Third and Eleventh Circuits have concluded that COLI plans very similar to AEP's were economic shams. *In re CM Holdings*, 301 F.3d 96, 107 (3d Cir. 2002) ("[T]he transaction as a whole lacked economic substance, and thus was an economic sham."); *Winn-Dixie Stores, Inc. v. Comm'r*, 254 F.3d 1313, 1317 (11th Cir. 2001) ("[T]he broad-based COLI program lacked sufficient economic substance to be respected for tax purposes. . . ."), *cert. denied*, 535 U.S. 986 (2002). We reach the same conclusion in this case.

B. Whether particular aspects of the COLI plan were shams in fact

The district court also held that the dividends in the fourth through seventh years of AEP's COLI plan, among

other aspects, were shams in fact. After disregarding those parts of the plan that it concluded were factual shams, the district court held that the plan did not fit into the 4-of-7 safe harbor rule of IRC § 264. This analysis constituted an alternative basis for the district court's conclusion that AEP was not entitled to deduct the policy-loan interest purportedly incurred in 1996. AEP challenges the soundness of the court's sham-in-fact analysis. Because we conclude that the COLI plan as a whole was an economic sham, we need not reach this issue.

We observe, however, that the correctness of the district court's sham-in-fact analysis is far from clear. "Factual shams are 'transactions' that never actually occurred." *In re CM Holdings*, 301 F.3d at 108. This court's decision in *Kennedy v. Commissioner*, 876 F.2d 1251 (6th Cir. 1989), is consistent with this understanding of what constitutes a sham in fact. In *Kennedy*, the taxpayer tried to claim a deduction for "expenditures paid or incurred during the taxable year for the development of a mine or other natural deposit. . . ." *Id.* at 1254 (quoting 26 U.S.C. § 616(a)). This court upheld the tax court's disallowance of the claimed deduction because the underlying transaction was a factual sham: "[T]here is no evidence showing that any amounts invested by the taxpayers were spent on mining development of their plots. . . . The evidence here supports the trial court's finding that the investors' mineral claim leases were fictitious." *Id.* at 1254. Similarly, the tax court disallowed certain claimed deductions in *Forseth v. Commissioner*, 85 T.C. 127 (1985), where it determined that the underlying precious-metal transactions did not exist: "Petitioners have failed to prove that there was any actual gold or platinum, that there was

any real market or trading, or that there was any purpose, other than the avoidance of taxes, for any of the transactions in issue." *Id.* at 165. *Kennedy* and *Forseth* are examples of shams in fact because the purported transactions in those cases on which the taxpayers claimed deductions had not actually occurred.

In holding that the dividends in years 4-7 were factual shams, the district court below focused on the fact that they were generated by circular, cashless netting transactions. But there is nothing in the record indicating that these transactions did not actually occur. The district court's holding therefore seems to be extending the factual-sham doctrine beyond its generally accepted definition. In dicta, the Third Circuit has rejected the district court's conclusion on this point: "The loading dividends of years 4-7 were similar simultaneous netting transactions that 'actually occurred,' and are therefore not factual shams." *In re CM Holdings*, 301 F.3d at 108.

In sum, the soundness of the district court's sham-in-fact analysis is questionable. Having concluded, however, that AEP's COLI plan as a whole lacked economic substance, we decline to decide whether any particular aspects of AEP's COLI plan were factual shams.

III. CONCLUSION

For all of the reasons set forth above, we **AFFIRM** the judgment of the district court.

Appendix A

CONCURRENCE

DAVID A. NELSON, Circuit Judge, concurring. I fully concur in the judgment and in Judge Gilman's opinion. My only purpose in writing separately is to comment on a couple of matters that arose during the oral argument.

Counsel for AEP was asked at argument whether this case could be distinguished from *In re CM Holdings, Inc.*, 301 F.3d 96 (3d Cir. 2002). In his response, counsel pointed out that the record before us here contains expert witness testimony that was not available to the *CM Holdings* court.

The testimony in question was provided by a well-qualified economist and tax expert, Dr. Charles D. McLure, Jr. The central theme of Dr. McLure's testimony was that whether or not corporate-owned life insurance is purchased with borrowed funds, the tax advantage of such insurance is attributable to the fact that the "inside buildup" in the value of the insurance is exempt from taxation. Implicit in this testimony, as I understand it, is the proposition that where Congress has created such a tax preference — as it has done in exempting from taxation the interest paid on municipal bonds, for example — taxpayers should be free to accept Congress' implied invitation. to cash out on the preference.

I have no quarrel with this proposition, which is consistent, I believe, with *Woodson-Tenent Laboratories, Inc. v. United States*, 454 F.2d 637 (6th Cir. 1972), and the two cases on which that decision rested, *Campbell v. Cen-Tex, Inc.*, 377 F.2d 688 (5th Cir. 1967), and *Priester Machinery Co. v. United States*, 296 F.Supp. 604 (W.D. Tenn. 1969).

In all three of those cases the taxpayers used the proceeds of policy loans (loans that carried a four percent interest rate) in prepaying premiums on "key-man" insurance policies. The insurance policies had substantial net cash values that increased over time, and the insurance benefits payable on the deaths of the named insureds were substantially greater than the amounts of the loans. See, *e.g.*, *Priester*, 296 F.Supp at 608. The owners of the insurance policies could in a sense capture the value of the inside buildup by cashing the death benefit checks they received when the insured employees died,[1] and there was a meaningful chance that the policy owners would realize non-tax economic gains through premature employee deaths.

In the case at bar, by contrast, AEP paid interest rates that bore no relation to the market for secured policy loans and were roughly three times as high as the rate paid in the earlier cases.[2] Because of a contractual linkage between the policy loan interest rates and the rates credited to the values by which the loans were secured, AEP maximized the inside buildup by electing to pay artificially high loan interest rates.

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1. Death benefits are not geared to inside buildup, of course, but Dr. McLure accepted a suggestion by the government that death benefits represent one way in which "the cash value and the inside buildup within the cash value can translate into cash flows. . . ." Trial transcript p. 2416.

2. As government expert James Hoag explained, insurance companies can afford to charge low interest rates for policy loans because the loans, being secured by the policies themselves, carry no credit risk.

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As Dr. McLure conceded on cross-examination, AEP's higher inside buildup did not translate into cash flows when insured individuals died. Indeed, AEP never accessed *any* material part of the inside buildup through direct payments from the insurance company. AEP kept its insurance costs as low as possible by maximizing its use of withdrawals and policy loans while the insured individuals were alive, and it realized no significant mortality gains when the individuals died. This was because the insurance program required AEP to pay increased annual charges if the company realized death benefits that exceeded the insurer's actuarial projections.

Unlike the taxpayers in *Woodson-Tenent*, *Cen-Tex*, and *Priester Machinery*, AEP had no net equity in the insurance at the end of any policy year and, viewed from a long-term program-wide standpoint, the company did not stand to realize any gain upon the deaths of insured employees. In economic terms, I believe, the entire value of the inside buildup was converted into tax deductions for the artificially high interest AEP was paying. If I am correct in this, it does not seem to me that Dr. McLure's testimony can carry the day for AEP; the program at issue lacked the kind of economic substance that was necessary for it to pass muster under *Knetsch v. United States*, 364 U.S. 361 (1960).

A second point discussed at oral argument involved the consequences of a hypothetical catastrophe killing huge numbers of AEP personnel. If such a catastrophe would enable AEP to receive death benefits substantially in excess of its expenditures, that fact could lend economic substance to a program that would otherwise appear to lack substance. As I now understand it, however, not even catastrophic losses

of AEP personnel could trump the requirement that the cost of insurance charged be adjusted to reflect AEP's actual mortality experience.[3] In any event, there is no evidence, and it has not been argued, that a desire to insure against such a catastrophe played any part in AEP's decision to purchase the COLI program.

In summary, it looks to me as though AEP's sole purpose in purchasing the program was to buy tax deductions. Under *Knetsch*, as Judge Gilman's opinion explains, such a purchase must be treated as a sham transaction for tax purposes. And the fact that the tax savings AEP hoped to realize from the sham would have been used for perfectly legitimate business purposes cannot legitimize the transaction itself.

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3. In addition to requiring adjustment of the cost of insurance charges, the COLI program provided for the payment of "mortality dividends" as a means of implementing "mortality neutrality." This is one respect in which AEP's program differed from the program at issue in *Dow Chemical Co. v. United States*, __ F.Supp.2d __, __ (E.D. Mich. 2003) (noting the absence of mortality dividends from the challenged program).

APPENDIX B — OPINION OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF OHIO, EASTERN DIVISION DATED FEBRUARY 20, 2001

IN THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF OHIO EASTERN DIVISION

No. C2-99-724
JUDGE GRAHAM

American Electric Power, Inc., et al.,

Plaintiffs,

vs.

United States of America, et al.,

Defendants.

No. C2-98-304
JUDGE GRAHAM

American Electric Power, Inc., et al.,

Plaintiffs,

vs.

United States of America, et al.,

Defendants.

Appendix B

MEMORANDUM OPINION AND ORDER

Introduction

This is a tax refund suit initiated by American Electric Power Company, Inc. ("AEP") to recover an alleged overpayment of federal income tax with respect to its 1996 tax year. AEP is a public utility holding company organized under the laws of the State of New York. Its principal office is in Columbus, Ohio. AEP is one of the largest shareholder-owned electric utility companies in the United States, operating in Ohio, Indiana, Kentucky, Michigan, Tennessee, Virginia, and West Virginia. AEP owns various operating, service, and coal-producing subsidiary corporations. The amount of tax in dispute with respect to the 1996 tax year for all the AEP companies is $25,478,773. The resolution of the tax controversy in this case will affect other AEP tax years, including 1991 to 1995, 1997 and 1998.

This case arises out of AEP's participation in a highly leveraged broad-based program of corporate-owned life insurance ("COLI"), wherein AEP purchased life insurance policies on the lives of over 20,000 employees constituting most of its work force. AEP was the beneficiary of these life insurance policies. A substantial amount of the premium cost for the COLI policies was financed by loans secured by the cash value of the policies. The COLI program was designed to maximize the tax benefits of the deductibility of interest on the policy loans, the deferral of taxation on the increase in cash value, and the ultimate non-taxability of the death benefits.

Appendix B

The Internal Revenue Service ("IRS" or "government") has disallowed AEP's deductions for interest paid on the COLI policy loans for 1996. The government claims that the policy loans, dividends, and partial withdrawals of policy value, which were used to pay premiums, lacked factual or economic substance and were sham transactions, *i.e.*, that they were shams in fact. Alternatively, the government maintains that the AEP COLI plan, taken as a whole, had no practical economic consequences, other than the creation of income tax benefits, and therefore, was a sham in substance. The government also contends that when these transactions are viewed in their proper light, the relationship of AEP's borrowing to its net premiums, *i.e.* gross premiums minus dividends and partial withdrawals, the plan fails the "four of seven" test set forth in I.R.C. § 264(c)(1).[1] The Internal Revenue Code generally disallows deductions on amounts borrowed on an insurance policy to pay premiums. *See* I.R.C. § 264(a)(3). However, this exclusion does not apply if "no part of 4 of the annual premiums due during the 7-year period (beginning with the date the first premium on the contract to which such plan relates was paid) is paid under such plan by means of indebtedness[.]" § 264(d)(1) (known as the "four out of seven safe harbor").

AEP contends that its COLI plan and its use of policy loans, policyholder dividends, and withdrawals to pay premiums and accrued policy loan interest were all within the intendment of the provisions of the Internal Revenue Code that governed the federal income tax treatment of life insurance and the deductibility of interest on policy loans

1. Now codified as I.R.C. § 264(d)(1) but referred to herein as I.R.C. § 264(c)(1).

during the years in question. AEP asserts that the policy loans, dividends and policy withdrawals were real transactions. AEP also claims that its COLI plan had objective economic substance and was undertaken for a valid business purpose, and that the interest on the policy loans was properly deductible under I.R.C. § 163(a).

General principles of life insurance

This case involves many of the unique attributes of life insurance. There are two basic kinds of life insurance: term insurance, which, as its name implies, provides a death benefit for a specified term of years; and whole life insurance, which provides a death benefit throughout the lifetime of the insured. Term insurance policies are priced on the basis of the actuarially-determined cost of providing the stipulated death benefit during the term of the policy. This is referred to in the insurance industry as the cost of insurance ("COI"). The premium for a term insurance policy includes a profit for the insurance company, but the contract provides no benefits to the insured other than the death benefit. Whole life policies, on the other hand, are customarily priced to permit the accumulation of value in addition to the cost of providing the death benefit. These policies provide a benefit known as cash value, which may be accessed by the policyholder during the insured's lifetime through policy loans or withdrawals of policy value. The accumulation of cash value within the policy may be likened to a savings account. The cash value of the policy represents not only the excess of premiums over COI charges, but also additional credits added by the insurance company in the nature of interest. The source of these additional credits is the income

generated by the insurance company's investments. This additional contribution to cash value is referred to as "inside buildup."

The owner of a whole life insurance policy which has accumulated cash value has a contractual right to obtain a loan from the insurance company, referred to as a policy loan, whereby the policyholder pledges the cash value of the insurance policy as collateral for the loan. The loan is deemed to have been made from the general assets of the insurance company, not as a withdrawal from the accumulated cash value of the policy. If the insured dies before the loan is repaid, the amount of the loan and accrued interest is deducted from the death benefit payable under the policy. Some whole life insurance policies permit the policyholder to access the cash value by making withdrawals therefrom. Withdrawals reduce the death benefit; however, the policyholder has no obligation to repay amounts withdrawn, nor is there any interest obligation on the amount withdrawn.

Many whole life insurance policies have an additional mechanism for distributing benefits to the policyholder, known as dividends. Such policies, which are called "participating" policies, provide the opportunity for the insurance company to distribute additional value to the policyholder in the form of dividends. Dividends may be paid in cash, credited against premiums due, or they may be accumulated and added to the cash value. Generally, dividends are paid when the insurance company's operating results have exceeded its profit expectations and there are additional funds available for distribution to policyholders. Policyholders do not have a right to receive dividends, they are payable in the discretion of the insurance company.

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Today, there is a great deal of flexibility in the structuring of life insurance policies with respect to premiums, death benefits and other benefits. Premiums may range from a single payment to a lifetime of payments. They may be fixed or variable in amount. Death benefits may be fixed or variable and there are many permutations of other policy benefits, such as cash value, policy loans, and dividends. In the past, the traditional whole life insurance policy provided a fixed death benefit in return for fixed premiums payable for the lifetime of the insured, usually deemed to be ninety years. Such policies accumulated cash values in accordance with a schedule stipulated in the policy. The policyholder was not given any information about the insurance company's cost of providing the death benefit, the amount of premium allocated to cash value, or the rate at which additions would be credited to cash value. The investment or savings component of the life insurance contract was hidden. In the late 1970s, a new form of cash value life insurance, known as "universal life," was introduced to the market. In a universal life policy, all of the economic components of the policy are revealed. The introduction of universal life had a significant impact on the life insurance industry by providing a product that could be marketed with an emphasis on investment goals and returns. With the introduction of universal life, the flexibility of life insurance as an investment vehicle was enhanced and the variations in the kinds of policies multiplied.

The tax advantages of life insurance

Historically, Congress has deferred taxation of the inside buildup that occurs within a cash value life insurance policy.

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Additionally, death benefits have been exempt from taxation. Congress has, however, regulated and limited these substantial tax benefits by imposing restrictions on the amount of the investment component which can be built into a life insurance policy and by regulating the extent to which policyholders are permitted to access cash values without incurring tax consequences.

Prior to the enactment of the Health Insurance Portability and Accountability Act of 1996 ("HIPA"), Pub. L. No. 104-191, 110 Stat. 1936, 2090, corporate policyholders enjoyed another significant tax advantage, namely the full deductibility of interest on policy loans. The combination of deferral of taxation of inside buildup, the exemption of taxation of death benefits, and the deductibility of interest on policy loans created the opportunity for tax arbitrage by corporate policyholders.[2] Not surprisingly, insurance industry entrepreneurs developed products for the corporate market which exploited this opportunity. Similar, although less sophisticated, products had been developed and marketed to high income individuals before Congress eliminated the deductibility of ordinary interest expense for individuals in the 1986 Tax Reform Act.

Corporate-Owned life insurance (COLI)

Corporations have, for many years, purchased life insurance on the lives of their most valuable employees in order to protect the corporation against economic losses

2. Whenever the aftertax cost of a policy loan is less than the amount being credited to inside buildup, it becomes profitable to purchase life insurance and pay for it with policy loans.

which would occur as a result of the untimely death of such an employee. This form of COLI is commonly known as key person life insurance. After it became widely accepted that corporations had an insurable interest in key employees, insurance companies began to market COLI as a funding vehicle for deferred compensation plans, where the lives of the beneficiaries of the deferred compensation plans, usually executive-level employees, were insured and the death benefits were used to fund the deferred compensation obligation. When these kinds of insurance programs began to exploit the tax arbitrage opportunities inherent in COLI, through the use of large policy loans, and the interest deductions which they generated, Congress reined them in by eliminating the interest deduction on policies in excess of $50,000. *See* I.R.C. § 264(a)(4)(B) (1994).

Insurance industry entrepreneurs soon found a way to circumvent this limitation by designing programs in which a corporation could purchase insurance policies on a large number or even all of its employees. These "broad-based" COLI plans could include any employee regardless of the length of employment or the value of the employee's services to the corporation. Thus, by increasing the number of policies issued, the opportunity for policy loans and loan interest deductions could be multiplied while remaining within the $50,000 per policy loan limit. These efforts to continue the exploitation of the tax arbitrage opportunities of COLI caused Congress to consider additional legislation to limit or eliminate the deductibility of interest on policy loans. It was in this context that AEP made its decision to purchase broad based COLI covering over 20,000 of its employees.

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Related Litigation

This is the third in a series of cases in which the IRS has challenged the deductibility of interest on policy loans in highly-leveraged broad-based COLI programs. *See Winn-Dixie, Inc. v. Comm'r*, 113 T.C. 254 (1999), and *In re C.M. Holdings, Inc.*, 254 B.R. 578 (D. Del. 2000). The *C.M. Holdings* case is particularly relevant because it involved the same COLI plan purchased by AEP which was offered by the same insurer and sold by the same brokers.

In *C.M. Holdings*, Camelot Music, Inc., a wholly-owned subsidiary of C.M. Holdings, Inc., purchased life insurance policies on the lives of 1,430 of its employees. The policies were in all relevant respects identical to those purchased by AEP. The arguments advanced by the parties were essentially the same as those advanced in the instant case. The IRS was represented by the same team of litigation counsel and the parties called most of the same witnesses who testified here, including the expert witnesses. The trial in *C.M. Holdings* commenced in late March, 2000, and lasted for six weeks. On October 16, 2000, Senior U.S. District Judge Murray M. Schwartz, issued a 143-page opinion, which marshals all of the facts and competing theories which these two highly complex cases share. The trial of the instant case commenced on October 30, 2000, and it also lasted six weeks. After thoroughly studying the court's opinion in *C.M. Holdings*, it is apparent that this court has been presented with essentially the same evidence and the same legal arguments. This court has independently reached many of the same conclusions as the court in *C.M. Holdings*. In the interests of brevity and judicial economy, this court will make liberal use of the opinion in *C.M. Holdings*.

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AEP's purchase of broad-based COLI

Historically, AEP has provided medical benefits to its retired employees. Prior to 1993, Generally Accepted Accounting Principles permitted corporations to account for postretirement medical benefits on a "pay-as-you-go" basis. Thus, AEP reported the costs of medical benefits for retired employees as an expense at the time the benefits were paid. In the mid-1980s, the Financial Accounting Standards Board ("FASB") announced that it was considering a change that would accelerate the recognition of postretirement medical benefits expense. Under this new method, postretirement medical benefits expense would be accrued and reflected in financial statements during the employees' working years. The FASB indicated that it would also require the creation of a "transition liability" to recognize that no prior expense accruals had been made for postretirement medical benefits. This change in accounting rules, known as FAS 106, was issued in 1990 and became effective in 1993.

Preliminary analysis performed by AEP staff and consultants in 1987 and 1988 indicated that FAS 106 would increase AEP's annual expense for postretirement medical benefits from approximately $10 million on the pay-as-you-go basis, to $60-$80 million on the new accrual basis. This increase in expense would significantly reduce AEP's reported net earnings.

In early 1989, AEP formed an internal task force on postretirement benefits and charged it with the responsibility to analyze the effects of proposed FAS 106 and to develop solutions to the problems it would create. AEP also requested

its actuarial consulting firm, Towers, Perrin, Foster & Crosby ("Towers, Perrin") to evaluate the impact of the anticipated changes.

As a public utility, AEP recovers the costs of providing services through rates charged to its customers, subject to the approval of federal and state regulators. It was unclear to AEP whether it would be permitted to pass on to consumers the incremental increase in benefits expense caused by FAS 106. AEP considered eliminating or severely reducing the medical benefits available to retirees but rejected this approach. AEP decided to attempt to recover its FAS 106 expenses through rate increases, and it sought ways to mitigate or offset its FAS 106 expense in order to enhance the possibility of obtaining the approval of regulators for rate increases.

AEP's consideration of purchasing broad-based COLI appears to have originated with AEP's accountants, DeLoitte Haskins + Sells ("DeLoitte"). In October of 1989, Robert S. Gorab of DeLoitte mentioned the use of COLI for the purpose of offsetting anticipated FAS 106 expenses in a telephone conversation with Gerald P. Maloney, AEP's chief financial officer. Gorab followed up by sending Maloney materials he had received from the insurance brokerage firm of Alexander and Alexander. These materials described a COLI plan offered by New York Life Insurance Company and included a paper entitled "METHODS TO PRE-FUND POST-EMPLOYMENT MEDICAL BENEFITS."[3] J1273. Maloney had prior

3. The New York Life COLI plan was similar in many respects to the Mutual Benefit Life COLI plan which AEP ultimately purchased.

experience with COLI in connection with the funding of senior executive's deferred compensation plans in 1982 and 1986, in which life insurance was purchased on the lives of key executives in order to fund the deferred compensation. Maloney assembled a group of AEP executives and employees to assist him in deciding whether to recommend COLI to AEP's top management, Chairman of the Board and Chief Executive Officer W.S. White, Jr. and Chief Operating Officer and President Richard S. Disbrow.

Maloney sent the Alexander and Alexander materials on to L.V. Assante, AEP's assistant treasurer, for his comments. On November 27, 1989, Assante, with the assistance of an AEP accountant, Hugh McCoy, provided Maloney with a memorandum containing an analysis of the New York Life COLI plan, which indicated that the plan would produce income that would offset a significant portion of the accruals for postretirement benefits expense over a thirty-year period. The memo concluded with the following statement:

> This appears to be a good funding vehicle over the long run but in the early years (and perhaps in total for AEP) it will not completely offset the increase in expense related to postretirement medical benefits that will result if the FASB's Exposure Draft becomes a final Statement.

J748.

In January, 1990, Maloney received another presentation on the use of COLI to fund postretirement medical benefits from James Campisi, who represented a joint venture between

his firm, The Newport Group ("Newport"), and the insurance brokerage firm of Johnson & Higgins.

Campisi provided Maloney with information regarding a COLI plan offered by Mutual Benefit Life Insurance Company ("MBL"), which included schedules showing the projected performance of the MBL COLI plan based on 20,000 employees and 7 annual premiums of $16,667 per employee. The COLI plan proposed by Campisi contemplated substantial policy loans during the first three years, with the proceeds applied to the payment of premiums. The premiums for the next four years would be largely offset by dividends and withdrawals of cash value and no premiums would be due after the seventh year. The projected performance of the plan produced positive cash flow and earnings every year for the life of the plan.

Maloney and the members of his group met with Campisi on January 26, 1990. Campisi explained the benefits of the MBL COLI program. Issues discussed at this meeting included: (1) whether AEP had an insurable interest in the employees sought to be covered; and (2) how the laws of the various states in which AEP had employees might affect that issue. Campisi pointed out that taxable income was necessary to realize the tax benefits contemplated by the program. Campisi offered to provide Maloney with a so-called "sweetheart letter" which guaranteed that the plan could be "unwound" any time before December 31, 1990, at no cost to AEP, in the event Congress and the President should approve tax legislation which would adversely affect the plan.

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On January 31, 1990, Campisi sent Maloney a packet of materials which included policy applications and prepayment agreements. Maloney asked McCoy to review Campisi's proposal and McCoy provided him with a memorandum dated February 6, 1990, with attached schedules. *See* J752. McCoy pointed out that after the first three years of the program, policy loans would total nearly $1 billion and would generate interest expenses of approximately $130 million per year.

On February 7, 1990, Maloney forwarded Campisi's materials on to Peter J. DeMaria, AEP's treasurer and chief accounting officer, and M.R. Luis, AEP's senior tax counsel. In this memorandum, Maloney commented on various aspects of the plan including the following:

> 8. I noted that the "tax benefit" amounts that are projected are very substantial and could possibly be challenged in some future audit by the IRS. Mr. Campisi stated that this coverage must qualify as "life insurance" under relatively objective and quantifiable standards of Section 7702 of the Internal Revenue Code; while it is possible that there could be such a challenge by IRS, there could be a reasonable defense because of compliance with those standards.

J753. Maloney concluded his memorandum by stating that he had asked Mr. Luis to look into the questions of (a) insurable interest in the lives of retirees, and (b) exposure to a challenge by the IRS of the deductibility of interest charges on policy loans.

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On February 8, 1990, Luis provided Maloney with separate memoranda concerning these issues. In his one-page memorandum on the issue of deductibility of interest on policy loans, Luis stated:

> Since the pending COLI program, if adopted, will generate substantial interest expense deductions, the IRS will scrutinize the transaction. If the COLI policies meet the section 7702 definition of a "life insurance contract" and if the requirements of section 264 of the Code are met, the transaction along with its favorable tax attributes should not be challenged.

Defendant's Exh. D209. Maloney was satisfied with Luis's response.

The materials Campisi originally provided to Maloney were premised on a variable policy loan interest rate, which had a current rate of approximately thirteen percent. Maloney asked Campisi to provide him with additional schedules containing projections of performance based on lower policy loan interest rates. Campisi provided Maloney with this information in a letter dated February 7, 1990, which pointed out that the COLI plan provided a choice between 3 formulas for variable rates which, based on current rates, produced interest charges of 13.11%, 12%, and 10.91%. *See* J968. In each instance, the difference or "spread" between the policy loan interest rate and the crediting rate on encumbered cash value was fixed at one percent. Maloney selected the second option which produced a current policy loan interest rate of twelve percent. Maloney testified that he selected the

middle rate because it approximated the rate AEP was then paying on its highest quality debt securities.[4] He said he rejected the lowest rate because he wanted to maximize tax-deferred inside buildup and that he declined the highest rate because he thought it was too high and less defensible if questioned by the IRS. Maloney could have chosen an eight percent fixed rate but he gave that option no consideration because it would have been detrimental to the performance of the plan.

Maloney convened another meeting of his group on February 12, 1990. Maloney prepared a checklist for this meeting, which included an item entitled "IRS Disallowance of Interest Deduction." This item included a reference to obtaining an opinion by AEP's outside counsel, Simpson, Thatcher & Bartlett, followed by a question mark. Maloney testified that he ultimately decided to rely on Luis's one-page memo instead of seeking an opinion from outside counsel, believing that he would receive the same opinion from outside counsel. At the conclusion of the February 12th meeting, Maloney decided to recommend that AEP proceed with the COLI program and instructed Campisi to prepare to bind coverage. Maloney informed AEP Chairman and Chief Executive Officer W.S. White, Jr. of his recommendation and inquired whether board approval would be necessary. White accepted Maloney's recommendation and advised that board approval would not be necessary.

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4. AEP's 1990 Annual Report indicates that its rate for first mortgage financial bonds was nine and one-eighth percent in September 1989. *See* J928.

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White signed applications and prepayment agreements for 8 AEP operating companies on February 16, 1990, and on the same date checks were written by the AEP operating companies in an aggregate amount in excess of $4 million. On February 21, 1990, Maloney and Campisi appeared before the AEP Board to explain the COLI plan the company had just purchased.

Maloney acknowledged that there was some urgency involved in consummating the purchase of the COLI plan because of the possibility that Congress might enact legislation restricting or eliminating the tax advantages of COLI. According to Maloney, however, everyone believed that existing plans would be "grandfathered" if that should occur.

Shortly after executing the policy applications, AEP, at the suggestion of Campisi, considered assigning the policies to a "grantor trust"[5] sited in Georgia in order to realize substantial savings on premium taxes which would generate significant additional cash flow during the first five years of the COLI plan. Luis was given responsibility for completing this project. An appropriate trust agreement was

5. The term "grantor trust" is used by tax lawyers to describe a trust of the type described in sections 671-679 of the Code. The grantor of this form of trust retains sufficient powers over the trust, usually the power to revoke at will, that the trust is considered, for tax purposes, as the *alter ego* of the grantor. Although the trust is required to file a Federal income tax return, that return is essentially an information return that reports all income and expense as attributable to the grantor and includible by the grantor on its Federal income tax return. *See Black's Law Dictionary* 1516 (7th ed. 1999).

prepared and executed on March 21, 1990. Campisi had advised that this should be done no later than March 22, 1990 because of potential adverse tax legislation and fear that a later date might jeopardize "grandfathering" the plan.

On March 20, 1990, the chief executive officers of each of the AEP subsidiaries executed a revocable trust agreement assigning the MBL COLI policies on the subsidiaries' employees to the Citizens and Southern Trust Company of Georgia, Trustee. The trustee accepted the assignments and executed the trust agreement on March 21, 1990.

The COLI policies were delivered on approximately March 23, 1990 and the balance of the cash portion of the first year's premiums was transmitted by the AEP subsidiaries to the trustee which, in turn, paid MBL. The policies were made effective on February 16, 1990, the date of the prepayment agreements. The policy loans, which were used to finance a substantial part of the first year's premium, were backdated to February 16, 1990, so that AEP could take advantage of the interest deduction for the entire year.

AEP's voluntary employees beneficiary association

The transition liability that FAS 106 required companies to report as a liability on their balance sheet can be reduced by the fair value of assets segregated and restricted to be used for post-retirement benefits. Prior to the adoption of FAS 106, AEP had funded health plans for active employees through contributions to a Voluntary Employees Beneficiary Association ("VEBA"). While it was considering the COLI plan, AEP also considered creating a VEBA to fund the

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FAS 106 transition liability, and it ultimately did so. This VEBA, actually a partition of AEP's existing VEBA, was funded through the purchase of trust-owned life insurance ("TOLI") written by the Prudential Insurance Company of Newark, New Jersey. At its inception, this plan insured 845 employees under a group contract which was owned by the VEBA. Contributions to the VEBA are tax deductible and earnings on plan assets within the VEBA are sheltered from income tax. The VEBA, however, is not sufficiently funded to cover the full extent of AEP's FAS 106 postretirement medical benefit liability. When AEP sought rate increases from the state regulatory agencies to cover its FAS 106 liability, it represented that it had mitigated its FAS 106 expense by funding a VEBA and by purchasing broad-based COLI. AEP represented that it would contribute the earnings realized by its COLI program to the VEBA. All of the regulatory agencies approved this approach and approved rate increases commensurate with the FAS 106 expense reductions which AEP projected would result from the VEBA and its COLI plan.

The money contributed to the VEBA, which was invested in the TOLI plan, was used to purchase variable term life insurance policies, wherein the cash values would reflect the performance of a bond fund and the Standard and Poor's 500 Stock Index. Mr. Maloney testified that the TOLI plan has performed very well, earning close to a twenty percent per year increase in the S & P fund component and approximately 7% per year in the bond fund component. Unlike the COLI plan, the TOLI plan does not rely on the tax deductibility of interest on policy loans.

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Development Of MBL COLI Plan

The idea behind the MBL COLI Plan was conceived in 1985 by Henry F. McCamish ("McCamish"), a life insurance entrepreneur. McCamish retained Milliman and Robertson ("M & R"), a nationally prominent actuarial consulting firm, to develop a new type of COLI product. McCamish asked M & R to design a COLI policy for large corporations that had policy value at the end of the first policy year that exceeded the first year's premium, so that the policy value would support a policy loan large enough to cover most of the first-year premium. He also stipulated that the policy should generate positive earnings and cash flow in the first plan year. Stephen Eisenberg ("Eisenberg"), Managing Consulting Actuary of M & R's life insurance practice, was the principal architect of this new form of COLI. He was assisted by Timothy Millwood, another M & R actuary. In designing the policy, Eisenberg had to ensure that it complied with all pertinent existing provisions of the Internal Revenue Code, including I.R.C. §§ 264 and 7702. Thus, Eisenberg had to design a plan in which the policyholder would not take policy loans in four out of the first seven policy years.

McCamish, who was a personal friend of the president of MBL, procured MBL's agreement to underwrite the new COLI product being designed by Eisenberg. James Van Etten, an actuary employed by MBL, collaborated with Eisenberg while he was designing the policy. McCamish formed two corporations that provided administrative and consultive services for the new MBL COLI policies, Integrated Administration Services, Inc. ("IAS") and IAS Development

Corporation ("IDC"). As compensation for these services, MBL agreed to pay McCamish and his companies a policy administration fee for every COLI policy sold, as well as a percentage of the annual premiums generated by the policies.

By early 1986, M & R, MBL and McCamish had developed MBL policy form FA85, which was designated as "COLI I". Thereafter, policy form FA85 was modified at various times in response to changes in the tax laws and competitive pressures in the marketplace. The modifications were made by adding a series of endorsements or amendments to the form. Each new version of the policy was sequentially numbered in Roman numerals. The COLI III policy was created in late 1986 in response to the amendment of I.R.C. § 264, which limited the deductibility of policy loan interest to $50,000 per insured. The COLI III policy initiated the use of dividends to offset payments of premiums in four out of the first seven policy years. The COLI V policy modified COLI III by making premiums payable for only a defined number of years. It contemplated that premiums would stop once the policyholder reached the $50,000 loan limit of I.R.C. § 264(a)(4)(B) and the requirements of the four out of seven safe harbor of § 264(c)(1) had been satisfied. Thus, the premiums stopped after seven years, and thereafter, the policyholder would hold the policies under an extended term nonforfeiture option. Finally, the COLI VIII policy modified COLI V by reducing the amount of premium per $1,000 of death benefits. This was done to ensure compliance with I.R.C. § 7702(a), which placed a cap on the premium per thousand in life insurance contracts.

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Features of AEP's COLI VIII policies and plan

The COLI VIII policies purchased by AEP were issued by MBL on policy form FA85 with endorsements EFA85-3, EFA85-4, EFA85-6, and EFA85-7. The policies are denominated on their face "Increasing Death Benefit Whole Life" with "premiums fixed and payable during lifetime of insured or until end of premium period" and "Eligible for Dividends." While the amount of the death benefit would vary depending upon the age of the insured employee, the remaining terms of each of the policies were identical. Each had a fixed annual premium of $16,667.

The policies provided for three interest rates: (1) the policy loan interest rate; (2) the loaned crediting rate, called the "Current Credited Loan Interest Rate," which was the rate at which the company would increase the amount of the cash value of the policy used to secure policy loans; and (3) the unloaned crediting rate, called the "Current Unloaned Interest Rate," which was the rate at which the company would increase the amount of the cash value not used to secure policy loans.

The loan interest rate and the loaned crediting rate were set as follows. The policies permitted AEP to annually elect between a fixed or variable loan interest rate. The fixed loan interest rate was 8% per annum if charged in arrears or 7.4%, if charged in advance. If AEP selected the fixed loan interest rate, the loaned crediting rate would be the greater of a rate declared by MBL or 4%. If AEP elected the variable loan interest rate, the loan interest rate would be the greater of: (1) the Moody's Corporate Band Yield Average—Monthly

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Average Corporate[6] ("Moody's Corporate Average") or (2) the loaned crediting rate plus 1%. Under the MBL COLI policy form, the loaned crediting rate would be equal to Moody's Corporate Bond Yield Average — Monthly Corporate Baa.[7] ("Moody's Baa"). Moody's Baa has always exceeded Moody's Corporate Average by 0.60% to 1.00%. Accordingly, the second prong of the variable loan interest rate provision would always govern and the loan interest rate would always be equal to the loaned crediting rate plus one percent.

Under endorsement EFA 85-3, the loaned crediting rate was calculated according to the following mathematical formula:

$$\frac{\text{Baa} + \text{T\%}}{100\% - \text{Baa}}$$

This formula produces a rate higher than Moody's Baa even when T = 0. This rate (T = 0) will be referred to as "Moody's Baa enhanced." While AEP was considering the MBL COLI plan, it was given a choice of variable loan interest rates which were determined by adding 1% to 3 possible loaned crediting rates: Moody's Baa (based on the standard policy form FA 85); Moody's Baa enhanced (based on endorsement

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6. Moody's rates investment grade corporate bonds as Aaa, Aa, A, and Baa, with Baa being the riskiest and having the highest interest rate. The Moody's Corporate Average is the composite average of the interest rates on all of these investment grade bonds combined.

7. Moody's Corporate Bond yield average — monthly corporate Baa, is the composite average of the interest rates on Baa rated bonds.

EFA 85-3 with T equal to 0); and Moody's Baa enhanced plus 1% (based on endorsement EFA 85-3 with T equal to 1). AEP chose Moody's Baa enhanced, which resulted in a loaned crediting rate of eleven percent and a policy loan interest rate of twelve percent. As a result, the policies were issued with endorsement EFA 85-3 and the factor "T" was set at 0.

Before it purchased the COLI policies, AEP was provided with sets of financial projections called "issue illustrations" which demonstrated how the COLI plan would perform in terms of cash flow and earnings. An issue illustration entitled "Scenario II" demonstrated the projected performance of the plan based on the policy loan interest rate AEP selected. *See* J968. This issue illustration demonstrated how the COLI policies were intended to be operated and the economic benefits they were expected to produce during the first 20 years of the plan, based on a corporate income tax rate of 37% and 20,000 insured employees. The following table (J968) shows the cash flow analysis presented in Scenario II for the first ten years of the plan.

SCENARIO II
CORPORATE OWNED LIFE INSURANCE

CASH FLOW ANALYSIS
(000's OMITTED)

	USE OF FUNDS					SOURCE OF FUNDS			
YEAR	CORP. PREMIUM	A/T ADMIN FEE	GROSS LOAN INTEREST	ANNUAL POLICY LOAN	TAX BENEFIT	CASH DIVIDENDS	CASH VALUE WITHDRAWALS	NET TAX FREE INSURANCE PROCEEDS	ANNUAL CASH FLOW
1990	333,340	252	0	312,360	13,864	0	0	10,860	3,492
1991	332,900	0	37,440	334,360	28,686	0	0	11,220	3,926
1992	332,440	0	77,440	351,900	44,248	12,680	0	11,580	10,528
1993	331,940	0	119,500	0	44,182	295,860	115,400	12,380	16,382
1994	331,400	0	119,300	0	44,095	293,720	114,420	13,200	14,735
	1,662,020	252	353,680		175,075	602,260	229,820	59,240	49,063
1995	330,800	0	119,080	0	44,008	291,540	113,360	14,080	13,108
1996	330,160	0	118,860	0	43,921	290,980	112,240	15,020	13,141
1997	0	252	118,600	0	43,834	0	92,160	18,160	35,302
1998	0	252	118,340	0	43,725	0	87,600	22,660	35,393
1999	0	252	118,040	0	43,616	0	81,960	28,220	35,504
	2,322,980	1,008	946,600		394,181	1,184,780	717,140	157,380	181,513

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The MBL COLI VIII policies were designed to have fixed annual premiums payable on the first day of each policy year. AEP selected the highest possible annual premium of $16,667 per policy, which permitted the accumulation of $50,000 in cash value in the shortest possible time, i.e. three years. The first year's total premium was calculated at $333,340,000. Premiums for the next 6 years were projected to be in the range of $331 million to $333 million. During the first through third years, the plan called for AEP to pay approximately ninety percent of the annual premiums through policy loans in simultaneous netting transactions in which the loans were offset against the premiums. Instead of paying $330 million in cash for the first year's premium, AEP would actually pay about $21 million (plus $2.5 million in first-year administrative fees.) This cash payment of approximately $23.5 million would be offset by the tax benefit of deducting the policy loan interest expense ($13.8 million) and by the receipt of tax-free insurance proceeds in the amount of $10.8 million. The net result would be positive cash flow of approximately $3.5 million the first year. Positive cash flow increased to approximately $3.9 million the second year, $10.5 million the third year and then quickly escalated to an amount in excess of $35 million per year by the eighth policy year.

After the third policy year, AEP could no longer finance the premiums with policy loans since this would violate the $50, 000 per policy loan limit of I.R.C. § 264 and forfeit the tax deductibility of the policy loan interest. The COLI policies were designed so that in years four through seven, most of the annual premiums and accrued loan interest would be paid by dividends and partial withdrawals in simultaneous netting

transactions, which would occur on the first day of each of those policy years. In these annual transactions, approximately ninety-five percent of the annual premium was considered taken by MBL as an expense charge. After setting aside amounts sufficient to cover MBL's actual expense charges, the remainder was returned to AEP as a "loading dividend" offsetting ninety-five percent of the premiums due.

No additional premiums were due after year seven and the loading dividends ceased. The policy loans remained in effect, however, generating interest expense in excess of $100 million annually, which was substantially offset by cash value withdrawals. Positive cash flows in the range of $35 million to $39 million were projected through year 20.

The AEP COLI VIII policies were projected to have a net equity equal to zero at the end of each and every policy year. The net equity, also known as cash surrender value, is equal to the total policy value, less policy loans and accrued interest. When a policy has a net equity equal to zero, all of the policy value is encumbered and it cannot support any additional policy loans. The designers of the MBL COLI plan used a sophisticated computer program to perform the calculations necessary to achieve this result.

AEP's MBL COLI program was designed to be "mortality neutral," to wit, the program's design was that the cumulative COI charges that AEP paid would equal the cumulative death benefits that it would receive, minus a profit margin to MBL of 20% of COI in the first year, 10% the second year and 2% each year thereafter. The concept of mortality neutrality was explained and described in M & R documents as follows:

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> Since the sale is tax driven, mortality should play a neutral role in performance. That is, clients usually do not expect to make or lose money on their mortality experience. They expect to realize the illustrated cash flows each year.

D325.

> Policyholders typically do not buy these products for mortality gains. They only expect to be treated fairly with respect to mortality.
>
> They expect COI rates will increase if experience so indicates. Likewise, they expect that favorable experience will result in increased policyholder dividends. In other words, COLI policyholders enter these contracts as a partnership with the insurance carriers with neither party taking advantage of the other party.

D580. MBL's commitment to mortality neutrality was reflected in a mortality dividend declared in 1991 for all plans issued through 1989 and a pledge to make annual mortality dividends thereafter, if mortality experience continued to prove more favorable to the company than expected. MBL's successor, Hartford, carried out this commitment to mortality neutrality by instituting experience rated dividends for the ten largest COLI plans, including AEP. Campisi advised AEP that "this mortality mechanism will result in a much closer match between expected cash flow from projected death benefits and claims that are actually paid. This will eliminate any volatility or variation in the cash flow that we are expecting in each year of the plan." D387.

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The essential features of the AEP MBL COLI VIII plan can be summarized as follows. First, the COLI plan had a very high policy value on the first day of the first year of the policy. This was made possible by the highest possible premium per policy and the broad base of employees insured. The high first year policy values were also made possible by the agents foregoing first-year commissions. Second, the high policy values were used to secure maximum policy loans, which paid a substantial amount of the premiums due in the first three policy years and also produced substantial interest deductions that, when combined with projected tax free death benefits, fueled positive cash flows. Third, computer technology enabled maximum leveraging of the high policy values through programs designed to achieve zero net equity at the end of each policy year. Fourth, AEP had the right to select among crediting rates for the inside buildup on the loaned portion (*i.e.*, virtually all) of the policy value, which automatically determined the policy loan interest rate because of the one percent spread between the loaned crediting rate and the policy loan rate. Fifth, the one percent spread essentially fixed AEP's cost of borrowing with the counter-intuitive result that the higher the loan interest rate paid by AEP, the greater the cash flow to it as a result of higher interest deductions. Sixth, the COLI VIII plan had an extremely high expense load component in policy years four through seven, which was used to create first-day dividends, which were used to pay most of the premium charges for those years. Finally, the actual cost of providing the death benefits was carefully calibrated to equal the amount of death benefits which AEP would receive over the life of the plan so that, except for MBL's modest profit on COLI profit, there would be no gain or loss based on mortality experience.

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Thus, through a preplanned, highly structured and calibrated combination of features, AEP's broad-based leveraged COLI plan was designed to produce positive cash flows in each and every plan year using the tax benefits of the deductibility of policy loan interest, deferral of taxation of inside buildup, and nontaxation of death benefits to transform paper losses into positive earnings and to generate substantial positive cash flows totaling over half a billion dollars at the end of twenty years.

The sham transaction doctrine

The government contends that the loading dividends, policy loans, and partial withdrawals that are all components of AEP's MBL COLI plan are factual shams. The sham transaction doctrine originated with the Supreme Court decision of *Gregory v. Helvering*, 293 U.S. 465 (1935). In *Gregory*, the Court affirmed the Commissioner's denial of deductions claimed by taxpayers for losses and expenses incurred in a corporate reorganization. Although the taxpayers had followed each step required by the Internal Revenue Code for the reorganization, the Court nonetheless held these losses nondeductible, finding that the transaction was a "mere device" for the "consummation of a preconceived plan" and not a reorganization within the intent of the code as it then existed. *Id.* at 469. Because the transaction lacked economic substance, it was not "the thing which the statute intended." *Id.*

The sham transaction doctrine requires the court to examine a challenged transaction as a whole and each element thereof to determine if the substance of the transaction is consistent with its form. *See ACM P'ship v. Comm'r*,

157 F.3d 231, 247 (3rd Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999). If the form of a transaction complies with the Code's requirements for deductibility, but the transaction nevertheless lacks factual or economic substance, then expenses or losses incurred in connection with the transaction are not deductible. *See Knetsch v. United States*, 364 U.S. 361, 369 (1960); *United States v. Wexler*, 31 F.3d 117, 122 (3rd Cir. 1994), *cert. denied*, 513 U.S. 1190 (1995).

The burden of proof is on the taxpayer to show that the form of the transaction reflects its substance. *National Starch and Chem. Corp. v. Comm'r*, 918 F.2d 426, 429 (3rd Cir. 1990) ("burden is on the taxpayer to show that the expenses are deductible") *aff'd sub nom INDOPCO, Inc. v. Comm'r*, 503 U.S. 79 (1992); *Goldberg v. United States*, 789 F.2d 1341, 1343 (9th Cir. 1986). While a taxpayer can legitimately structure a transaction to minimize tax liability under the Code, the transaction must nevertheless have factual and economic substance. *See Gregory*, 293 U.S. at 469.

AEP contends that the sham transaction doctrine includes a threshold requirement which requires the court to first determine "whether the thing done was the thing intended by the statute." Plaintiff's Post-Trial Memorandum at p. 32. According to AEP, if the court determines that the thing done was indeed the thing intended, the court need not and should not proceed to examine the issue of whether the transaction has economic substance. AEP argues that Congress has, over the years, carefully tailored the tax laws relating to the favorable treatment of life insurance, and since AEP's COLI plan satisfies all of the statutory requirements for the tax favored treatment of inside buildup, death benefits, and policy

loan deductions, the plan satisfies the statutory intendment test and the judicial inquiry is at an end. AEP's statutory intendment test is taken from the following language in *Gregory*:

> The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended.

Gregory, 293 U.S. at 469 (citations omitted). AEP reads too much into this statement. Certainly, the Court did not mean that satisfying all of the statutory requirements precludes a court from examining either the factual reality or the economic substance of the questioned transaction. Indeed, in *Gregory*, the Supreme Court went on to note: "[n]o doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance," and "[t]he whole undertaking, though conducted according to the terms [of the statute] was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else." *Id.* at 469-70. AEP's statutory intendment test would effectively swallow up the economic substance test and vitiate the sham transaction doctrine. A transaction which has no factual reality or economic substance can never be the thing the statute intended even though the form of the transaction satisfies all of the requirements of the statute.

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AEP argues that the Supreme Court's opinion in *Hanover Bank v. Comm'r*, 369 U.S. 672 (1962) and the Sixth Circuit's opinion in *Humphreys v. Comm'r*, 301 F.2d 33 (6th Cir. 1962) are "clear examples of the application of the statutory intendment standard." Plaintiff's Post-Trial Memorandum at p. 35. However, neither of these cases support AEP's argument. In *Hanover Bank*, the question before the Court was one of pure statutory construction. The Court specifically noted that the "Government does not contend that the transactions entered into by the petitioners were a sham without any business purpose except to gain a tax advantage." *Hanover Bank*, 369 U.S. at 681. In *Humphreys*, the Sixth Circuit specifically found that "[i]t cannot be controverted that the purchase of the bonds and the gifts to charity were real genuine transactions though motivated by tax considerations." *Humphreys*, 301 F.2d at 33-34. Neither case involved the application of the sham transaction doctrine.

The taxpayers in *C.M. Holdings*, and *Winn-Dixie* raised arguments similar to AEP's statutory intendment argument and they were rejected. *See C.M. Holdings*, 254 B.R. at 36 and *Winn-Dixie*, 113 T.C. at 290, 294. This court agrees.

Courts have recognized two basic types of sham transactions: (1) "shams in fact," in which the reported transactions never occurred; and (2) "shams in substance" in which the transactions "actually occurred but which lack the substance their form represents." *Kirchman v. Comm'r*, 862 F.2d 1486, 1492 (11th Cir. 1989); *see also ACM P'ship*, 157 F.3d at 247 n.30; *Lerman v. Comm'r*, 939 F.2d 44, 49 n.6 (3d Cir. 1991). The government claims that the loading dividends, policy loans, and partial withdrawals under AEP's

MBL COLI plan are factual shams and that the AEP MBL COLI plan as a whole was a sham in substance because it was devoid of economic substance apart from the policy loan interest deductions.

Sham in fact doctrine as applied to components of the AEP COLI PLAN Policy loans

The government contends that the policy loans were factual shams. Here, in addition to the decisional law relating to the sham transaction doctrine, the government relies on a separate body of case law defining interest and indebtedness for the purpose of determining the deductibility of interest under I.R.C. § 163. This line of cases stands for the proposition that interest and indebtedness must be real in order to support a deduction. *See Knetsch*, 364 U.S. at 369; *Wexler*, 31 F.3d at 122; *Goldberg*, 789 F.2d at 1343; *Bridges v. Comm'r*, 325 F.2d 180, 181-82 (4th Cir. 1963).

Section 163 allows a deduction for "interest paid or accrued within the taxable year on indebtedness." I.R.C. § 163. "Interest" represents compensation for the use or forbearance of money. *Old Colony R. Co. v. Comm'r*, 284 U.S. 552, 561-62 (1932). "Indebtedness" under I.R.C. § 163 is defined as "an unconditional and legally enforceable obligation for the payment of money." *Autenreith v. Comm'r*, 115 F.2d 856, 858 (3rd Cir. 1940).

According to the government, AEP's COLI policy loans and their associated interest deductions lacked both factual and economic reality because: 1) the COLI loan interest rates were not determined by the market in an arm's-length

transaction but were arbitrarily chosen in a collusive arrangement for the purpose of maximizing interest deductions; 2) they violated industry standards governing maximum permissible loan interest rates; and 3) the rates were excessive and unjustifiable from a financial perspective. Most of the arguments advanced by the government for the proposition that the policy loans were factual shams are more appropriately addressed to the issue of whether the policy loans were economic shams.

The court is satisfied by a preponderance of the evidence that the policy loans were not factual shams. The COLI policy loans were considered real debts of AEP, which had to be repaid when the insured employee died or if the policy lapsed. Whenever an insured employee died, the death benefit was reduced by the outstanding policy loan and unpaid interest. MBL and its successor, Hartford Life Insurance Company ("Hartford") carried the policy loans as assets on their books and recorded them separately from the receipt of premiums. In the aftermath of HIPA, AEP repaid the loans on all policies in excess of 20,000 employees with substantial amounts of cash.

All insurance policy loans seem rather unreal when compared to ordinary commercial loans. It is the longstanding custom and practice in the insurance industry that policy loans are deemed as made from the general funds of the insurance company, with the policy value serving only as collateral. They are not considered withdrawals of cash from the policy value itself. As the court observed in *C.M. Holdings*:

> One can think of the life insurance company acting somewhat like a bank, lending money to the

> policyholder from its general funds, with the policy value pledged as collateral.

C.M. Holdings, 254 B.R. at 602. The fact that the policy loans were made on the first day of each policy year does not deprive them of reality. There is precedent in the industry for first-day, first-year policy loans. It is not unusual for policy loans to be applied to offset premiums in a simultaneous netting transaction. First-day, first-year policy loans that were credited against premiums were not regarded as factual shams in *Campbell v. Cen-Tex, Inc.*, 377 F.2d 688 (5th Cir. 1967) and *Woodson-Tenent Labs., Inc. v. United States*, 454 F.2d 637 (6th Cir. 1972).

The risk characteristics of the loans do not affect their factual reality. Indeed, all life insurance policy loans are devoid of most of the major risk factors which are present in commercial loans. It is the custom of the industry to set interest rates on policy loans without reference to the risk factors that attend ordinary commercial loans.

The government's argument that the policy loan interest rate was set at an artificially high rate in a collusive non-arms-length transaction does not implicate the reality of the transaction. Interest rates on insurance policy loans are always determined in private transactions between the insurance company and the policyholder, and are customarily determined by the terms of the insurance contract issued by the insurance company and accepted by the policyholder. There is no market rate for such loans, as there is in the case of real estate mortgages or commercial loans. There is ample precedent for variable rates based on standards such as Moody's Corporate Average. Fixed spreads between policy

loan interest rates and cash value crediting rates are not unusual. The fact that the MBL COLI policies gave the policyholder a choice of rates higher than Moody's Corporate Average, by linking them to Moody's Baa (plus a choice of enhancements), does not affect the reality of the loans.

Backdating of the first-year policy loans

When AEP decided to participate in the MBL COLI plan, it entered into prepayment agreements, which were signed on February 16, 1990, wherein the AEP companies agreed to pay $200 per insured to purchase insurance from the date of the prepayment agreements to the date of policy issue. The prepayment amount was to be applied to the first premium due if the policies were issued. Under the terms of the prepayment agreements, coverage was to end on the earlier of: 1) sixty days from the date of the prepayment agreement; 2) the date the policies were issued; 3) the employer's failure to pay premiums on policy delivery; or 4) upon MBL' s disapproval of the application for insurance. The prepayment agreements expressly provided that "accumulation or credit of interest on policy values and charges for policy loan interest as provided in the policy shall accrue only from the date of policy issue." J761. Thus, the prepayment agreements did not require AEP to pay any policy loan interest until MBL actually issued its policies.

The policies were issued and delivered on March 23, 1990. The policies and the policy loans were backdated to the date of the prepayment agreements, February 16, 1990, and AEP claimed interest deductions on the policy loans from that date. AEP was not obligated to pay any loan interest during the period of the prepayment agreement. No loans

existed during that period. MBL did not provide AEP with any funds during that period, nor did any policies exist which could be have been used as collateral for policy loans. McCamish's company, IAS, which was responsible for the administration of the MBL COLI policies, originally calculated the interest on the first year of the policy loans based upon an inception date of March 23, 1990, the date the policies were delivered. This was later changed at the urging of Campisi after AEP complained that it reduced the projected positive after-tax cash flow for the first year from $3,000,000 to a little over $1,000,000.

The illusory nature of the inception date of the policy loans and the fictitious obligation for the period from February 16, 1990, to March 23, 1990, is further revealed by the fact that the COLI policies were deemed to have been transferred to a grantor trust on March 21, 1990. Thus, by backdating the policy loans, the trust purportedly became liable for interest for a period predating its legal existence. The predating of the policy loans and the creation of an interest obligation for the period February 16th through March 23, 1990, were shams in fact.

While there was evidence presented showing that it is common in the life insurance industry to issue a conditional receipt at the time of taking an application for life insurance and to provide death benefit coverage from the date of the receipt — after it has been determined that the insured meets the company's underwriting requirements — there was no evidence presented of a custom or practice to backdate policy loans in the manner in which it was done in the instant case. The court concludes that the manner in which IAS originally

intended to calculate the first-year policy loan interest is more likely the industry norm for a transaction of this kind.

Loading dividends and premiums in policy years four through seven

The government contends that the loading dividends which offset most of the premium expense in policy years four through seven were factual shams. In *C.M. Holdings*, the court aptly described these transactions as follows:

> In the simultaneous netting transaction involving the loading dividends, the premiums come from the policyholder, the loading charges come from the premiums, the loading dividends come from the loading charges, which dividends are then used by the policyholder to pay the premiums. Since the funds for each component is source from another component in a circular transaction, the entire transaction is simply a paper ruse.

C.M. Holdings, 254 B.R. at 608.

It is standard practice for life insurance policies to have loading charges to cover the insurance company's expenses in administering the policy. It is also standard practice to assess loading charges greater than the anticipated expenses in order to provide a reasonable margin of safety to cover unpredictable expenses, to make a permanent contribution to surplus, and to provide for the payment of dividends in the event of favorable experience. However, such charges customarily have a reasonable relationship to the insurance company's risk of incurring higher than expected expenses.

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The government experts provided credible expert testimony that margins of five to ten percent would be generous.

There is some degree of flexibility in industry practices with respect to the amount of loading charges, which relates to how a company wishes to present itself in the market place with respect to premiums and dividends. Higher premiums permit the payment of higher dividends and lower dividends result in lower premiums. The loading dividends in this case are nevertheless far beyond the range of standard industry practices.

The following table shows the expense loads assessed in the MEL COLI policies as a percent of gross premium and MBL's actual anticipated policy expenses as a percent of gross premium for policy years one through seven:

Plan Year	Contractual Expense Loads (As % of Gross Premium)	MBL's Anticipated Policy Expenses (As % of Gross Premium)
1	10%	4.0%
2	20%	8.8%
3	30%	8.8%
4	95%	8.8%
5	95%	9.3%
6	95%	9.3%
7	95%	9.3%

D561.

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In years four through seven, the contractual expense load was ninety-five percent of the gross premium, whereas MBL's actual anticipated policy expenses as a percentage of gross premium was less than ten percent. The excess was the source of the huge loading dividends, which offset nearly all of the gross premiums for those years. Thus, on the first day of each of the policy years four through seven, the entire premium and accrued interest were deemed paid by AEP. At the same time, eighty-eight percent of the premium was deemed paid back to AEP as a dividend in order to offset the premium obligation.

The New York Department of Insurance rejected MBL COLI policy endorsement EFA-4 which provided for the loading dividends. In a letter dated February 10, 1988, the New York Department wrote to M & R stating:

> We need to turn attention to the expense loads . . . and both the pattern and level of these charges are shocking[.] We do not see how these charges can be justified as reflecting real expenses reasonably expected to be incurred by the insurer and the use of such charges in the cost structure is misleading. The gross premiums should not be loaded up through the use of fictitious expense loads.

(D108).

The loading dividends bear no relationship whatsoever to MBL's anticipated policy expenses. They exist only for the purpose of offsetting most of the premium charges

ostensibly due in years four through seven. The premiums for these four years were set at an artificially high level, not because they were needed to cover the costs of operating the policy or to provide a reasonable margin for dividends, but to make sure that the policies did not violate the four out of seven safe harbor rule of I.R.C. § 264(c)(1).

Implicit in the four out of seven safe harbor rule is the requirement that the annual premiums must remain level for the first seven years of the policy. *See C.M. Holdings*, 254 B.R. at 645, 646. AEP acknowledges that this is the case. *See* Plaintiffs' Post-Trial Memorandum, p. 71, Doc. No. 124. The premiums for years four through seven had to stay at the same high level as years one through three in order to preserve the right to deduct policy loan interest expense. The premiums for years one through three were set high in order to support the maximum permissible policy loans of $50,000 per policy in the shortest time in order to generate the maximum amount of tax deductible interest expense as quickly as possible. The loading dividends were devised as a way to immediately return the unnecessary and excessive portion of the premiums in years four through seven. This so-called dividend was in reality a rebate or reduction of premium. As dividends, they were a sham in fact.

The excessive loading dividends in policy years four through seven cannot be justified under industry practices. *See C.M. Holdings*, 254 B.R. at 612-18. It is a standard of the industry that dividends are paid from surplus. Surplus is calculated based on an insurance company's experience over the preceding year. Here, the source of the loading dividend was not surplus but the excessive loading charge built into the premiums. The dividend was credited at the beginning

of the year, not the end of the year and was not based on experience in the usual sense of that term. The court cannot accept the testimony of AEP's experts who attempted to show that surplus could somehow be instantaneously created and immediately returned as a dividend in a simultaneous netting transaction. There is no credible evidence of an industry practice which would support this contention.

Dividends are by definition discretionary. Guaranteed distributions cannot qualify as dividends. The loading dividends were an integral part of the COLI plan. They were virtually guaranteed by being built into the premiums and they were represented as virtually guaranteed to prospective policyholders. *See id.* at 16.

State accounting regulations and industry practice require insurance companies to create a liability on their balance sheets for all dividends. Neither MBL nor Hartford set up a liability on their books for the loading dividends. During the design of the COLI VIII policy, MBL officers expressed concern about the company's failure to establish a dividend liability on the company's books and suggested that the loading dividends be relabeled as a "premium rate adjustment." Van Etten rejected this suggestion, saying it was "not viable" because "it would reopen Section 264 issues with all of our existing clients with potentially disastrous results." J46. Van Etten's comments reflect his understanding that if the loading dividends were acknowledged as premium adjustments rather than dividends, the gross premiums in years four through seven would not be level as required by I.R.C. § 264 and the policyholder's policy loan interest deductions would be disallowed.

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Hartford's failure to establish a liability for the loading dividend was called into question by the Connecticut Department of Insurance during its examination of Hartford's 1993 financial statements. After examining the loading dividend, the Connecticut Department ultimately concluded that Hartford was not required to establish a year-end liability because the loading dividend was not really a policy dividend but rather a "premium refund." *See* D392 at p. 30; Gies Tr. 2988-89.

For all of the foregoing reasons, the court finds that the loading dividends in years four through seven were factual shams. It follows that the grossly excessive premiums in years four through seven were likewise factual shams.

First-year dividend

Part of the first-year policy loan was made possible by $26 million in dividends, which were instantly added to the first-year policy values and simultaneously borrowed as part of the $319 million in first-year policy loans.[8] These, dividends are indistinguishable from the loading dividends in years four through seven and were a factual sham for the same reasons given above.

Loading dividends as the economic equivalent of a non-guaranteed element other than a dividend

AEP argues that for federal tax purposes, dividends are broadly defined to include any distribution to a policyholder

8. These dividends were "declared" by the board of MBL in November, 1989, three months before AEP purchased the COLI policies.

that is the economic equivalent of a dividend. AEP cites, *inter alia*, I.R.C. § 808(a) and (b), which provides in part:

> (a) **Policyholder dividend defined.** — For purposes of this part, the term "policyholder dividend" means any dividend or similar distribution to policyholders in their capacity as such.
>
> (b) **Certain amounts included.** — For purposes of this part, the term "policyholder dividend" includes —
>
> (1) any amount paid or credited (including as an increase in benefits) where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management[.]

Section 808 relates to an insurance company's ability to deduct distributions to policyholders. AEP argues that this broad definition of dividends undermines the government's argument that the loading dividends are factual shams. The court disagrees.

Generally, a taxpayer cannot disavow the form of its transaction absent "proof which in an action between the parties to the agreement would be admissible to alter the construction or to show its unforceability because of mistake, undue influence, fraud or duress." *Schatten v. United States*, 746 F.2d 319, 321-22 (6th Cir. 1984) (quoting *Comm'r v. Danielson*, 378 F.2d 771, 775 (3rd Cir.)) (*en banc*),

cert. denied, 389 U.S. 858 (1967); *Spector v. Comm'r*, 641 F.2d 376, 382 (5th Cir. 1981), *cert. denied*, 454 U.S. 868 (1981); *see also North American Rayon Corp. v. Comm'r*, 12 F.3d 583, 586 (6th Cir. 1993).

MBL chose to designate the return of eighty-eight percent of the premiums in years four through seven as dividends instead of partial withdrawals or nonguaranteed elements in order to take advantage of the reduction in premium tax which occurs when premiums are paid with policy dividends. Having accepted the financial benefit of that characterization, AEP cannot now argue that what was labeled as a dividend was really something else. In the final analysis, however, it makes no difference how the return of premium is labeled, it remains a sham because it was simply a paper ruse, engaged in to make it appear as though level premiums were being paid during the first seven years of the policy when, in fact, they were not.

Partial withdrawals

The MBL COLI VIII plan anticipated that partial withdrawals of cash value would be taken annually, commencing with the fourth policy year to be used to offset loan interest expense. The government initially claimed that these partial withdrawals were factual shams but did not include that claim in its post-trial brief. Be that as it may, the court concludes that these withdrawals were real. *See C.M. Holdings*, 254 B.R. at 618-19.

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Sham in substance/economic substance doctrine as applied to the AEP COLI plan as a whole

The court will now turn to the question of whether the AEP COLI plan was a sham because it lacked economic substance.

The United States Court of Appeals for the Sixth Circuit has described the economic substance test as an inquiry into "whether the transaction has any practicable economic effect other than the creation of income tax losses." *Rose v. Comm'r*, 868 F.2d 851, 853 (6th Cir. 1989); *see also Pasternak v. Comm'r*, 990 F.2d 893, 898 (6th Cir. 1993); *Smith v. Comm'r*, 937 F.2d 1089, 1094 (6th Cir. 1991); *Bryant v. Comm'r*, 928 F.2d 745, 748 (6th Cir. 1991). In *Rose*, the court said, "A taxpayer's subjective business purpose and the transaction's objective economic substance may be relevant to this inquiry." *Rose*, 868 F.2d at 853. Thus, in determining whether the questioned transaction has economic substance, the court should look to both the taxpayer's subjective business purpose and the transaction's objective economic substance. It appears that the standard in the Sixth Circuit is consistent with the standard adopted in other circuits, including the standard enunciated by the Third Circuit in *ACM Partnership*. There, the court stated:

> The inquiry into whether the taxpayer's transactions had sufficient economic substance to be respected for tax purposes turns on both the "objective economic substance of the transactions" and the "subjective business motivation" behind them. However, these distinct

> aspects of the economic sham inquiry do not constitute discrete prongs of a "rigid two-step analysis," but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes.

157 F.3d at 247 (citations omitted). In discussing the objective aspect of the economic sham analysis, the *ACM* court noted that "the courts have examined 'whether the transaction has any practical economic effects other than the creation of income tax losses[.]' " *Id.* at 248 (quoting *Jacobson v. Comm'r*, 915 F.2d 832, 837 (2d Cir. 1990)). The court went on to state that courts:

> have refused to recognize the tax consequences of transactions that were devoid of "non-tax substance" because they "did not appreciably affect [the taxpayer's] beneficial interest except to reduce his tax."

Id. (quoting *Knetsch v. United States*, 364 U.S. 361, 366 (1960)).

AEP argues that in determining whether its COLI plan had objective economic substance, *i.e.*, whether it had any practicable economic effects other than the creation of income tax losses, the court should not consider the economic consequences of the transaction on a pretax basis since, unlike most other investments, life insurance has a built in tax preference in the deferral of taxation of inside buildup.

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It is clear from the evidence, however, that the COLI plan was marketed by MBL and its brokers and purchased by AEP with a primary focus on the benefits of the deductibility of policy loan interest. For example, in testimony before the Federal Energy Regulatory Commission, Hugh McCoy, an AEP accountant, explained the operation of the COLI plan as follows:

> It's the tax deductibility, the tax advantage of the COLI program, which makes it work, which creates the net income and the cash flow.
>
> The insurance program itself, prior to the tax effects, has a cost, a small cost, because it covers 20,000 people on a system-wide basis. But it has a cost and it's a tax benefit that turns it into a favorable item, both earnings and cash flow.

D570, pp. 478, 479.

It is the combination of tax-deferred inside buildup and the deductibility of policy loan interest that creates the opportunity for tax arbitrage, which was the real motivation for AEP's purchase of the COLI policies. The success of the plan depended not only on the interest deductions generated by policy loans but also on the deferral of taxation on inside buildup and the exemption of taxation of death benefits. The latter benefits are inherent in all whole life insurance policies, but, the benefit of tax arbitrage can be realized only if there are substantial policy loans which generate tax deductible interest expense.

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AEP never considered financing its MBL COLI plan with cash but, instead, made its decision to purchase the MBL COLI VIII policies based on projections of aftertax cash flow and earnings generated by the maximum amount of policy loans permitted under the law and the highest policy loan interest rate it thought would pass I.R.S. scrutiny. Therefore, it is appropriate to consider the economic substance of the COLI plan in the usual way by comparing the plan's economic effects on a pretax and posttax basis. The only recognized exception to this approach is found in cases in which courts have discerned a congressional purpose to encourage investment where an economic loss would be anticipated without tax benefits. *See, e.g., Sacks v. Comm'r*, 69 F.3d 982 (9th Cir. 1995) (tax credits and accelerated depreciation to encourage investment in solar energy).

In the case at bar, there is no evidence of congressional intent to encourage corporate investment in life insurance. Indeed, to the contrary, the legislative history in the area of corporate owned life insurance, suggests a congressional intent to discourage tax driven insurance investments while, at the same time, preserving "the importance of being able to borrow on insurance policies . . . for other than tax saving purposes." *H.R.Rep. No.* 749 (1963), *reprinted in* 1964 U.S.C.C.A.N. 1313, 1370; *see also S.Rep. No.* 830 (1964), reprinted in 1964 U.S.C.C.A.N. 1673, 1750; *McLane v. Comm'r*, 46 T.C. 140, 143 (1966), *aff'd*, 377 F.2d 557 (9th Cir. 1965) ("The history of the provisions dealing with the deductibility of interest on indebtedness incurred or continued to carry life insurance reflects the constant 'push' by Congress to keep abreast of the 'pull' of ingenious schemes to take advantage of loopholes."); *see also C.M.*

Holdings, 254 B.R. at 624 ("Congress appears to be in a perpetual game of catch up with the innovative geniuses of the life insurance industry, constantly trying to plug up perceived holes in the tax code regarding the deductibility of policy loan interest[.] . .").

The sales illustrations provided to AEP before it purchased the COLI program show that the financial results of the plan were economically dependent upon the tax benefits generated by the policy loan interest deductions. The economic projections based on the policy loan interest rates selected by AEP show that in each year, absent the tax savings from the policy loan interest deduction, AEP's cash flows would be negative. The total before tax cash flow at the end of 20 years, which included over $900 million in tax-free death benefits, was still a negative $268,854,000. The tax savings, which resulted from the deduction of the policy loan interest, totaled $820,573.00, producing a positive cash flow of $551,719,000. *See* J968. Without the policy loan interest deductions, the MBL COLI VIII plan would have been a financial disaster for AEP.

The objective element of the economic sham analysis requires the court to search the transaction to determine whether it has any practical or economic effects, other than the creation of income tax losses. This requires the court to examine the transaction to see if it appreciably affected the taxpayer's beneficial interest except to reduce its tax. An investment in whole life insurance offers two potential economic benefits: 1) a death benefit which exceeds the cost of insurance in the event of the premature death of the insured person and 2) the accumulation of tax-deferred inside

buildup. Mortality neutrality and zero net equity eliminated both of these economic benefits in the AEP COLI plan.

Because the plan was designed to be mortality neutral, it was anticipated that over the life of the plan, the death benefits would equal COI charges, minus MBL's modest profit on COI. Thus, AEP could not anticipate any financial advantage from the payment of death benefits. Neither would AEP benefit from tax-deferred inside buildup, because the plan contemplated that literally every penny of inside buildup would be used to support policy loans.[9] The court concludes that the AEP COLI plan did not appreciably affect AEP's beneficial interest except to reduce its tax.

AEP points out that over the period from 1990 to 1998, it was projected to receive death benefits in the amount of $222.7 million but that its actual death benefit receipts were $183.9 million—a shortfall of $38.8 million. No doubt, most of this discrepancy occurred before MBL/Hartford instituted an experience rating system to "fine tune" the matching of death benefits to insurance charges, and while the shortfall experienced by AEP is a significant sum of money, it did not appreciably diminish the projected tax-generated benefits of the program.

AEP argues that its investment in the MBL COLI VIII plan had economic substance because, unlike the plans

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9. MBL recognized that the zero net equity feature was a significant indicator of the COLI VIII plan's lack of economic substance and removed the net equity column from its sales illustration because it produced an "uninterrupted string of zeros." *See C.M. Holdings*, 254 B.R. at 632.

considered in *Knetsch v. United States*, 364 U.S. 361 (1960), and other cases,[10] the economic consequences of the COLI VIII plan were not "locked" from the outset by fixed interest rates. While it is true that the variable policy loan interest rate and the loaned crediting rate in the COLI VIII policies were subject to change, the spread between the rates was "locked" at one percent, which guaranteed an aftertax gain. The amount of the aftertax gain and positive cash flow was not expected to precisely match the projections and AEP understood this when it purchased the policies. The fact that the amount of the tax savings could, and did in fact, vary, does not imbue the transaction with economic substance.

AEP argues that the independent status of its subsidiaries and the disparate economic impact of the COLI plan on the subsidiaries compels a finding that the plan was not a sham in substance. In support of this argument, AEP cites *Moline Props. v. Comm'r*, 319 U.S. 436 (1943) and *Humana Inc. v. Comm'r*, 881 F.2d 247 (6th Cir. 1989). In *Moline*, the taxpayer asked the Court to disregard its corporate existence and treat gains on the sale of its real estate as individual income to its sole shareholder. The Court refused, holding that the corporation had a tax identity distinct from its stockholder. In *Humana*, the court held that sums paid by a parent corporation to a wholly-owned captive insurance subsidiary on behalf of the parent's other wholly-owned subsidiaries were deductible as ordinary and necessary business expenses because there was risk shifting between the wholly-owned

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10. *See, e.g., Goldstein v. Comm'r*, 364 F.2d 734 (2nd Cir. 1966) *cert. denied*, 385 U.S. 1005 (1967); *Winn-Dixie Stores, Inc. v. Comm'r*, 113 T.C. 254 (1999).

subsidiaries. The parent corporation argued that the separate corporate existence of its subsidiaries must be respected for the purposes of the risk-shifting analysis and the court agreed.

Here, the taxpayer, AEP, chose to treat itself and its wholly-owned subsidiaries as a single entity with respect to the tax consequences of its COLI plan by filing a consolidated U.S. Corporation Income Tax Return. Furthermore, AEP's decision to purchase the COLI VIII policies was based on its assessment of the benefits of the plan to the AEP system as an economic unit—without consideration of its potential impact on the individual corporate subsidiaries. It follows that an analysis of the economic substance of the plan should focus on the economic consequences to AEP, not its wholly-owned subsidiaries.

Economic consequences to non-taxpayer parties

An analysis of objective economic substance includes an assessment of the transaction's economic consequences to nontaxpayer parties involved in the transaction. *See Frank Lyon Co. v. United States*, 435 U.S. 561, 580 (1978). MBL/Hartford reported premiums due under the COLI contracts for purposes of state and federal premium taxes. They also reported policy loan interest as income for state and federal tax purposes. None of this reporting altered the insurance companies' net economic position. The costs of state and federal premium taxes were included in the actual expenses of the COLI VIII policies and were reimbursed by AEP. The policy loan interest income reported by the insurance companies was offset by the amounts they contributed to

inside buildup and, as a result, they paid income tax only on the one-percent spread between those rates. The economic consequences of the transaction to the insurance companies does not give the MBL COLI plan objective economic substance.

The policy loans and interest charges

As noted above, loans made by an insurance company to its policyholder, secured by the cash value of the life insurance policy, are distinctly different from typical commercial loan transactions. The unusual attributes of insurance policy loans are supported by longstanding customs and practices in the life insurance industry. There is also precedent for some of the more unusual features of the MBL COLI loans, such as first day, first-year loans, and the netting of loan proceeds against premiums. These considerations weighed heavily in the court's determination that the MBL COLI policy loans, while unusual on their face were, nevertheless, real. However, there are other unusual features of the MBL COLI loans, which place them far from the mainstream of traditional industry practices.

The designers of the COLI policy devised a mechanism by which policyholders, like AEP, through a range of available loan interest rates, could choose to inflate their own interest costs, thus inflating their interest deductions and, ultimately, increase the aftertax earnings and cash flow from the arrangement. They did this by inventing a loan interest rate formula which exploited a loophole in the National Association of Insurance Commissioners ("NAIC") model

bill governing policy loan interest rates.[11] The section of the

11. The pertinent provisions of the model bill are as follows:

Section 2. Definitions

For purposes of this Act the "Published Monthly Average" means:

A. The Moody's Corporate Bond Yield Average—Monthly Average Corporates as published by Moody's Investors Service, Inc. or any successor thereto; . . .

Section 3. Maximum Rate of Interest of Policy Loans

A. Policies issued on or after the effective date of this Act shall provide for policy loan interest rates as follows:

(1) A provision permitting a maximum interest rate of not more than eight percent (8%) per annum; or

(2) A provision permitting an adjustable maximum interest rate established from time to time by the life insurer as permitted by law.

B. The rate of interest charged on a policy loan made under Subsection A(2) shall not exceed the higher of the following:

(1) The Published Monthly Average for the calendar month ending two months before the date on which the rate is determined; or

(Cont'd)

model bill relating to variable rates provides that the rate shall not exceed the higher of (1) Moody's Corporate Average or (2) the rate used to compute the cash surrender value plus one percent. The designers of the COLI policy specified Moody's Baa as the base rate for computing the cash surrender value of the policy. Moody's Baa always exceeds Moody's Corporate rate, therefore, in the case of the MBL COLI policy the rate referred to in the second prong of the model bill will always be higher than the rate referred to in the first prong, effectively freeing the MBL COLI policy from the limitations of the model bill. *See infra*, pp. 56, n.14.

The NAIC model bill represented an industry-wide consensus on the appropriate maximum variable loan interest rate for life insurance policy loans and it became law in most of the states, including Ohio. *See* Ohio Rev.Code § 3915.051. The drafters of the model bill intended the Moody's Corporate Average to be the maximum legal rate. That average is based on the average rate of a composite of investment grade corporate bonds.

The designers of the MBL COLI policy circumvented the intended maximum policy loan interest rate of the model bill and established a rate based on Moody's Baa, the most risky component of the Moody's Corporate Average, a rate

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(Cont'd)

> (2) The rate used to compute the cash surrender values under the policy during the applicable period plus one percent per annum.

Pl. Exh. P199.

that has historically been 60 to 100 basis points[12] higher than Moody's Corporate Average. Then, they increased that rate by one percent. This resulted in a policy loan interest rate 160 to 200 basis points higher than the maximum intended by the model bill. Later, with the advent of endorsement EFA 85-3, they permitted the policyholder to chose even higher rates, resulting in "junk bond" rates for risk free policy loans. Camelot, the taxpayer in *C.M. Holdings*, chose the highest of the three options offered by MBL. AEP chose the second highest, constrained by the fear that the I.R.S. might disallow its interest deductions if it chose the highest rate.

The insurance department of MBL's state of domicile, New Jersey, rejected endorsement EFA 85-3,[13] stating:

> This change to the current credited loaned interest rate has a direct impact on the policy loan rate. We feel that it is inappropriate for a policyholder to determine within a range what these two rates will be. The premise of the variable loan interest rate is to charge a rate dependent upon an outside index, and the methodology used to determine the credited interest rate should rely on company expectation, not policyholder discretion.

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12. A "Basis point" is 1/100 of one percent.

13. The endorsement was likewise rejected by Pennsylvania, New York, Texas and Oregon. Other states approved endorsement EFA 85-3 but it is not clear what level of scrutiny, if any, the endorsement received in these states.

Appendix B

D84. When a transaction is structured so that the borrower actually benefits from a higher loan interest rate and the borrower is permitted to chose its own interest rate from a range of rates that begins with a rate that far exceeds the industry maximum, the interest rate component of the transaction lacks economic substance.[14]

AEP argues that its motivation for choosing the Moody's Baa enhanced rate was to increase tax-deferred inside buildup. But the projections provided to AEP showed that all of the additional inside buildup would be encumbered by policy loans and accrued loan interest. Thus, AEP could not expect to derive any nontax economic benefit from the higher inside buildup. Instead of increasing inside buildup the higher interest rate was intended to produce larger loans and larger interest deductions. When Campisi presented the interest rate options to AEP, his presentation focused on the policy loan interest rate and the tax deductions it would generate, not the tax-deferred inside buildup. *See* J968. AEP's evaluation of the economic benefits of the COLI plan likewise focused on the tax benefits of the policy loan interest deductions.

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14. New York refused to approve the policy loan interest rate provision of the COLI policy because it exceeded the maximum intended by the NAIC model bill. An M & R actuary in New York reported to Eisenberg in September, 1986 that the New York regulators had "pointed out, correctly (and you and I have discussed this) that in theory if this approach is taken it is not necessary to use either a Baa index or for that matter any index at all; one could, for example, credit 24% and charge 25%." and "This got us into a discussion about what the IRS would or would not regard as a reasonable provision (as opposed to a sham) for tax purposes[.]" G73.

Appendix B

What AEP received for its cash payments to MBL/Hartford

The amount of cash paid by AEP to MBL/Hartford in any given year was precisely equal to the sum of the COI charges; policy expenses (including brokers' commissions, fees to McCamish and his companies and state premium taxes); and the one-percent spread between the policy loan interest rate and the loaned crediting rate. Because the COLI VIII plan was designed to be mortality neutral and called for policy loan borrowings which produced zero net equity throughout the life of the plan, the plan functioned much like term insurance. Viewed in this light, AEP substantially overpaid for the insurance coverage provided by the COLI program. The evidence revealed that the net cost of AEP's death benefit coverage for a 42-year-old male employee during its fifth policy year was $502.07. Yet, AEP's fifth-year cash payment for this policy was $2,120.10, which is 257% more than the actual cost of the death benefit. The difference is attributable to broker's commissions, McCamish's fees, and MBL/Hartford's one percent profit on the policy loans. What AEP received for this 257% markup on the cost of the death benefits was a fee for the facade of policy loans that were projected to produce nearly one billion dollars in tax deductions during the first twenty years of the plan which were essential to achieving the projected positive cash flow of over a half a billion dollars.

AEP's business purpose for participating in the MBL COLI VIII plan

AEP has established by substantial, credible evidence that its purpose for entering into the MBL COLI VIII plan

was to provide earnings and cash flow that would partially offset its increased employee benefits expense attributable to the implementation of FAS 106. AEP intended to use the COLI earnings and cash flows to offset reductions in earnings caused by FAS 106 and to fund the VEBA. This was a proper business purpose. However, this does not satisfy the subjective prong of the economic substance analysis, which requires the court to assess whether the transaction had a purpose other than creating tax deductions, not how the taxpayer intended to use the tax-driven proceeds. The proper test for determining whether a transaction is an economic sham "consists of an examination of the transaction, not the taxpayer." *Thomas v. United States*, 166 F.3d 825, 834 (6th Cir. 1999) (quoting *Illes v. Comm'r*, 982 F.2d 163, 166 (6th Cir. 1992)). If the transaction lacks economic substance, then the deduction must be disallowed without regard to the niceties of the taxpayer's intent. *See Mahoney v. Comm'r*, 808 F.2d 1219, 1220 (6th Cir. 1987).

AEP's intended use of the cash flows generated by the MBL COLI VIII plan is irrelevant to the subjective prong of the economic substance analysis. If a legitimate business purpose for the use of the tax savings "were sufficient to breathe substance into a transaction whose only purpose is to reduce taxes, [then] every sham tax-shelter device might succeed." *Winn-Dixie*, 113 T.C. at 287. AEP was free to use the earnings and cash flows generated by the MBL COLI VIII program for any purpose it wished. In a memo prepared early in the course of AEP's consideration of COLI, Maloney aptly described COLI as "an independent funding vehicle which could be applied to anything." D641. AEP's intent to use the tax-driven COLI earnings and cash flows to

help defray increasing postretirement medical benefit expenses does not imbue the COLI program with economic substance.

Similarity between AEP's COLI plan and the transaction in Knetsch v. United States

When the AEP MBL COLI VIII plan is stripped down to its bare essentials, it bears a remarkable resemblance to the transaction before the court in the landmark case of *Knetsch.* Carl F. Knetsch, in 1953, at the age of 60, purchased ten thirty-year maturity-deferred annuity savings bonds from the Sam Houston Life Insurance Company. Each bond was in the face amount of $400,000 bearing 2.5% interest compounded annually. The total purchase price was $4,004,000, which Knetsch paid by issuing a check for $4,000 and signing non-recourse notes for $4 million, bearing 3.5% interest. The notes were secured by the annuity bonds and interest on the loans was payable in advance. On the same day, Knetsch prepaid the first year's interest on the loans, which was $140,000. Under the table of cash and loan values made part of the bonds, their cash or loan value at the end of the first contract year was to be $4,100,000. The contract permitted Knetsch to borrow any excess of this value beyond his indebtedness without waiting until the end of the year. Knetsch promptly borrowed back $99,000, giving his check in the amount of $3,465 for a year's advance interest on that loan. In the two succeeding years, interest was paid and the loan values were borrowed. If the loans had been repaid, Knetsch would have been entitled to a monthly annuity of $90,171 per month at maturity when he would have been 90 years old. If, however, he continued to borrow and to pay

interest according to the pattern established in the first three years, the value of the contracts would never exceed $1,000 and would have produced an annuity of just $43 per month. Knetsch terminated the transaction in December, 1956, at which time his indebtedness totaled $4,307,000. The cash or loan value of the bonds was $4,308,000, which had been the basis of the loan of the prior year. He surrendered the bonds and his indebtedness was canceled. He received the difference of $1,000 in cash.

Knetsch, in his income tax returns for 1953 and 1954, claimed an interest deduction for the interest paid on the loans. The deduction was disallowed by the Commissioner and paid by Knetsch, who sued for a refund. The Supreme Court held that the indebtedness created by the borrowings was fictional and in reality a rebate of a substantial part of the so-called interest payments. The Court, likewise, held that the annuity contracts were fictional because their value was reduced to and by the annual borrowings, kept at "the relative pittance of $1,000." *Knetsch*, 364 U.S. at 366. The transaction did not, according to the Court, appreciably affect Knetsch's beneficial interest except to reduce his tax. Nothing of substance was to be realized by him beyond a tax deduction. The transaction was determined by the Court to be a sham. *See id.*

In *Knetsch*, the petitioners contended, as AEP does here, that Congress in enacting various provisions of the Internal Revenue Code authorized the deductions. They pointed out that I.R.C. § 264(a)(2), at that time, denied a deduction for amounts paid on indebtedness incurred to purchase a single premium annuity contract but only as to contracts purchased

after March 1, 1954. They attributed to Congress a purpose to allow the deduction of pre-1954 payments and the transactions of the kind carried on by Knetsch. The Court refused to attribute such an intent to Congress, stating: " '[t]o hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.' " *Knetsch*, 364 U.S. at 367 (quoting *Gregory v. Helvering*, 293 U.S. 465, 470 (1935)). In reaching this conclusion, the Court reviewed the legislative history of Congressional action with respect to the taxation of annuity contracts, which bears many similarities to the history of Congressional action in the area of taxation of life insurance policies. *See id.* at 367-370.

The similarities between Knetsch's annuity transactions and the AEP COLI VIII plan are striking. They include first-day, first-year loans, which paid for all but a small percentage of the total premium and generated substantial interest deductions. There was a pattern of annual borrowings, which consumed nearly all of the equity in the annuity bonds and produced even more tax-deductible interest expense. The potential economic benefit of the annuity bonds, substantial annuity payments thirty years hence, was wiped out by the borrowings. The only real benefit to Knetsch was the tax deductions.[15] Although three Justices dissented in *Knetsch*, it remains the law of the land and this court can find no principled way to distinguish the essential features of the AEP MBL COLI VIII plan from the essential features of the annuity transactions in *Knetsch*.

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15. The annuity bonds also provided a death benefit equal to the net cash value of the bonds at the time of death. *See United States v. Bond*, 258 F.2d 577, 579 (5th Cir. 1958).

Appendix B

Sixth Circuit precedent relied upon by AEP

AEP argues that controlling Sixth Circuit precedent upholds the deductibility of the policy loan interest on its COLI policy loans, citing *Woodson-Tenent Labs., Inc. v. U.S.*, 454 F.2d 637 (6th Cir. 1972) and *Campbell v. Cen-Tex, Inc.*, 377 F.2d 688 (5th Cir. 1967). The court disagrees. In *Woodson-Tenent*, the Sixth Circuit expressly adopted the rationale of the Fifth Circuit in *Campbell*, and of the district court in *Priester Mach. Co. v. United States*, 296 F.Supp. 604 (W.D. Tenn. 1969), finding *Knetsch* was not controlling for the reasons stated in those opinions. *See Woodson-Tenent*, 454 F.2d at 638-39.

The policies involved in *Woodson-Tenent* were key man life insurance purchased on the lives of two principal officers of the corporation. A substantial portion of the premiums were paid with policy loans. However, the court expressly noted that the death benefits of the policy were substantially in excess of the maximum indebtedness incurred to pay policy premiums. *See id.* at 640. Thus, unlike the instant case, the policyholder in *Woodson-Tenent* could potentially receive a substantial non-tax benefit from the policies. *Campbell v. Cen-Tex*, likewise, involved life policies on key employees and stockholders, which were purchased to assist the corporation in meeting its obligations under its deferred compensation plan and its obligation to purchase and redeem the stock of any deceased stockholder. There was a pattern of annual borrowings to pay the premiums on the policies. However, unlike the AEP COLI VIII plan, the policies in *Cen-Tex* had substantial net equity after twenty years. The court noted:

> [T]he policies would have, at the end of twenty years, with maximum loans effected, cash surrender values in excess of $200,000. These potential death benefits and cash surrender values cannot be brought within the *Knetsch* characterization of a "relative pittance."

Campbell, 377 F.2d at 693. Likewise, in *Priester Mach. Co.*, the policies were key man life policies and, although there was a pattern of annual borrowing to pay premiums, the policies had substantial increasing net equity at the end of each year. *See Priester Mach. Co.*, 296 F.Supp. at 606. The court distinguished *Knetsch* noting that:

> Here[,] on the other hand, the death benefits of the insurance policies were and would always be substantially greater than the loan and, further, taxpayers were acquiring substantial and increasing net cash values in the policies.

Id. at 608. Thus, *Woodson-Tenent*, *Cen-Tex* and *Priester Mach. Co.* are distinguishable from the instant case because the policies in those cases, unlike the AEP COLI VIII plan, provided substantial non-tax benefits to the policyholders.

Other cases relied on by AEP, including *Shirar v. Comm'r*, 916 F.2d 1414 (9th Cir. 1990); *Coors v. United States*, 572 F.2d 826 (Ct. Cl. 1978); and *Golsen v. U.S.*, No. 112-78, 1980 WL 4732 (Ct. Cl. Oct. 16, 1980), are likewise distinguishable. In *Shirar*, the policies would have built up significant net equity even with maximum policy loans. *See Shirar*, 916 F.2d at 1418-19. In *Coors*, the policyholder

paid cash premiums for the first several years its policies were in force before taking out policy loans to pay premiums after falling into economic difficulties. *See Coors*, 472 F.2d at 829.

The four out of seven safe harbor

The Internal Revenue Code generally disallows deductions for interest paid on policy loans taken against a life insurance policy, "which contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value" of the policy. I.R.C. § 264(a)(3). Section 264(c)(1) provides an exception and allows deductions for interest paid on policy loans taken against a life insurance policy so long as "no part of 4 of the annual premiums due during the 7-year period (beginning with the date the first premium . . . was paid) is paid under such plan by means of indebtedness."

Implicit in the four out of seven safe harbor rule is the requirement that the annual premiums must remain level for the first seven years of the policy. As noted earlier, AEP concedes that this is the case. In policy years four through seven, AEP purportedly paid the annual premiums on its COLI policy through a combination of partial withdrawals and loading dividends. However, the court has found that the loading dividends were factual shams. They were included in the premiums but immediately returned to AEP in a simultaneous netting transaction, which was a mere facade to make it appear as though the premiums in years four through seven were equal to the premiums charged in years one through three. In fact, the real premiums for years four

through seven were a small fraction of the premiums charged in years one through three; thus, the MBL COLI VIII plan violated the seven year level premium requirement of § 264(c)(1). AEP's COLI VIII policies contemplated "the systematic direct or indirect borrowing of part or all of the increases in the cash value" of the policies. Accordingly, I.R.C. § 264(a)(3) disallows AEP's deductions for interest paid on the policy loans and AEP is unable to avail itself of the exception provided by the § 264(c)(1) four out of seven safe harbor rule.

CONCLUSION

The court finds that the following components of the AEP COLI VIII plan were factual shams:

The first-year policy loans for the period February 16 to March 23, 1990; the first-year loading dividend and corresponding portions of the premium charges; and, the loading dividends and corresponding portions of the premium charges in policy years four through seven.

The court finds that the AEP COLI VIII plan as a whole was a sham in substance.

The court further finds that AEP's deductions for interest paid on policy loans with respect to the COLI VIII plan must be disallowed under the provisions of I.R.C. § 264(a)(3).

The Clerk shall enter final judgment in favor of the defendant at plaintiff's costs.

It is so ORDERED.

s/ James L. Graham
JAMES L. GRAHAM
United States District Judge

DATE: February 20, 2001

APPENDIX C — ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT DENYING PETITION FOR REHEARING AND WITHDRAWING CONCURRING OPINION DATED AND FILED JULY 9, 2003

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 01-3495

AMERICAN ELECTRIC POWER COMPANY, INC. AND AFFILIATED CORPORATIONS; AEP SERVICE CORPORATION; APPALACHIAN POWER COMPANY; CENTRAL OHIO COAL COMPANY; COLUMBUS SOUTHERN POWER COMPANY; CONESVILLE COAL PREPARATION; INDIANA MICHIGAN POWER COMPANY; KINGSPORT POWER COMPANY; OHIO POWER COMPANY; SOUTHERN OHIO COAL COMPANY

Plaintiffs - Appellants

v.

UNITED STATES OF AMERICA

Defendant - Appellee

ORDER

BEFORE: NELSON, COLE and GILMAN, Circuit Judges.

Upon consideration of the petition for rehearing filed by the appellants',

Appendix C

It is **ORDERED** that the petition for rehearing be, and it hereby is, **DENIED.**

It is further ORDERED that Judge Nelson's separate concurring opinion has been withdrawn.

ENTERED BY ORDER OF THE COURT

s/ Leonard Green
Leonard Green, Clerk

APPENDIX D — STATUTES INVOLVED

26 U.S.C. § 163

SEC. § 163. INTEREST

[Sec. 163(a)]

(a) GENERAL RULE.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

Source: Sec. 23(b), 1939 Code, substantially unchanged.

[Sec. 163(b)]

(b) INSTALLMENT PURCHASES WHERE INTEREST CHARGE IS NOT SEPARATELY STATED.—

(1) GENERAL RULE.—If personal property or educational services are purchased under a contract—

(A) which provides that payment of part or all of the purchase price is to be made in installments, and

(B) in which carrying charges are separately stated but the interest charge cannot be ascertained,

then the payments made during the taxable year under the contract shall be treated for purposes of this section as if they included interest equal to 6 percent of the average unpaid balance under the contract during the taxable year. For purposes of the preceding sentence, the average unpaid balance is the sum of the unpaid balance outstanding on the first day of each month beginning during the taxable year, divided by 12. For purposes of this paragraph, the term "educational services" means any service (including lodging) which is purchased from an educational organization described in section 170(b)(1)(A)(ii) and which is provided for a student of such organization.

(2) LIMITATION.—In the case of any contract to which paragraph (1) applies, the amount treated as interest for any taxable year shall not exceed the aggregate carrying charges which are properly attributable to such taxable year.

[Sec. 163(c)]

(c) REDEEMABLE GROUND RENTS.—For purposes of this subtitle, any annual or periodic rental under a redeemable ground rent (excluding amounts in redemption thereof) shall be treated as interest on an indebtedness secured by a mortgage.

Appendix D

[Sec. 163(d)]

(d) LIMITATION ON INVESTMENT INTEREST.—

(1) IN GENERAL.—In the case of a taxpayer other than a corporation, the amount allowed as a deduction under this chapter for investment interest for any taxable year shall not exceed the net investment income of the taxpayer for the taxable year.

(2) CARRYFORWARD OF DISALLOWED INTEREST.—The amount not allowed as a deduction for any taxable year by reason of paragraph (1) shall be treated as investment interest paid or accrued by the taxpayer in the succeeding taxable year.

(3) INVESTMENT INTEREST.—For purposes of this subsection—

(A) IN GENERAL.—The term "investment interest" means any interest allowable as a deduction under this chapter (determined without regard to paragraph (1)) which is paid or accrued on indebtedness properly allocable to property held for investment.

(B) EXCEPTIONS.—The term "investment interest" shall not include—

(i) any qualified residence interest (as defined in subsection (h)(3)), or

(ii) any interest which is taken into account under section 469 in computing income or loss from a passive activity of the taxpayer.

(C) PERSONAL PROPERTY USED IN SHORT SALE.—For purposes of this paragraph, the term "interest" includes any amount allowable as a deduction in connection with personal property used in a short sale.

(4) NET INVESTMENT INCOME.—For purposes of this subsection—

(A) IN GENERAL.—The term "net investment income" means the excess of—

(i) investment income, over

(ii) investment expenses.

(B) INVESTMENT INCOME.—The term "investment income" means the sum of—

(i) gross income from property held for investment (other than any gain taken into account under clause (ii)(I)),

(ii) the excess (if any) of—

(I) the net gain attributable to the disposition of property held for investment, over

(II) the net capital gain determined by only taking into account gains and losses from dispositions of property held for investment, plus

(iii) so much of the net capital gain referred to in clause (ii)(II) (or, if lesser, the net gain referred to in clause (ii)(I)) as the taxpayer elects to take into account under this clause.

(C) INVESTMENT EXPENSES.—The term "investment expenses" means the deductions allowed under this chapter (other than for interest) which are directly connected with the production of investment income.

(D) INCOME AND EXPENSES FROM PASSIVE ACTIVITIES.—Investment income and investment expenses shall not include any income or expenses taken into account under section 469 in computing income or loss from a passive activity.

Appendix D

(E) REDUCTION IN INVESTMENT INCOME DURING PHASE-IN OF PASSIVE LOSS RULES.—Investment income of the taxpayer for any taxable year shall be reduced by the amount of the passive activity loss to which section 469(a) does not apply for such taxable year by reason of section 469(m). The preceding sentence shall not apply to any portion of such passive activity loss which is attributable to a rental real estate activity with respect to which the taxpayer actively participates (within the meaning of section 469(i)(6)) during such taxable year.

(5) PROPERTY HELD FOR INVESTMENT.—For purposes of this subsection—

(A) IN GENERAL.—The term "property held for investment" shall include—

(i) any property which produces income of a type described in section 469(e)(1), and

(ii) any interest held by a taxpayer in an activity involving the conduct of a trade or business—

(I) which is not a passive activity, and

(II) with respect to which the taxpayer does not materially participate.

(B) INVESTMENT EXPENSES.—In the case of property described in subparagraph (A)(i), expenses shall be allocated to such property in the same manner as under section 469.

(C) TERMS.—For purposes of this paragraph, the terms "activity", "passive activity", and "materially participate" have the meanings given such terms by section 469.

(6) PHASE-IN OF DISALLOWANCE.—In the case of any taxable year beginning in calendar years 1987 through 1990—

(A) IN GENERAL.—The amount of interest paid or accrued during any such taxable year which is disallowed under this subsection shall not exceed the sum of—

(i) the amount which would be disallowed under this subsection if—

(I) paragraph (1) were applied by substituting "the sum of the ceiling amount and the net

investment income" for "the net investment income", and

(II) paragraphs (4)(E) and (5)(A)(ii) did not apply, and

(ii) the applicable percentage of the excess of—

(I) the amount which (without regard to this paragraph) is not allowable as a deduction under this subsection for the taxable year, over

(II) the amount described in clause (i).

The preceding sentence shall not apply to any interest treated as paid or accrued during the taxable year under paragraph (2).

(B) APPLICABLE PERCENTAGE.—For purposes of this paragraph, the applicable percentage shall be determined in accordance with the following table:

In the case of taxable years beginning in:	*The applicable percentage is:*
1987	35
1988	60
1989	80
1990	90

(C) CEILING AMOUNT.—For purposes of this paragraph, the term "ceiling amount" means—

(i) $10,000 in the case of a taxpayer not described in clause (ii) or (iii),

(ii) $5,000 in the case of a married individual filing a separate return, and

(iii) zero in the case of a trust.

[Sec. 163(e)]

(e) ORIGINAL ISSUE DISCOUNT.—

(1) IN GENERAL.—In the case of any debt instrument issued after July 1, 1982, the portion of the original issue discount with respect to such debt instrument which is allowable as a deduction to the issuer for any taxable year shall be equal to the aggregate daily portions of the original issue discount for days during such taxable year.

(2) DEFINITIONS AND SPECIAL RULES.—For purposes of this subsection—

(A) DEBT INSTRUMENT.—The term "debt instrument" has the meaning given such term by section 1275(a)(1).

(B) DAILY PORTIONS.—The daily portion of the original issue discount for any day shall be determined under section 1272(a) (without regard to paragraph (7) thereof and without regard to section 1273(a)(3)).

(C) SHORT-TERM OBLIGATIONS.—In the case of an obligor of a short-term obligation (as defined in section 1283(a)(1)(A)) who uses the cash receipts and disbursements method of accounting, the original issue discount (and any other interest payable) on such obligation shall be deductible only when paid.

(3) SPECIAL RULE FOR ORIGINAL ISSUE DISCOUNT ON OBLIGATION HELD BY RELATED FOREIGN PERSON.—

(A) IN GENERAL.—If any debt instrument having original issue discount is held by a related foreign person, any portion of such original issue discount shall not be allowable as a deduction to the issuer until paid. The preceding sentence shall not apply to the extent that the original issue discount is effectively connected with the conduct by such foreign related person of a trade or business within the United States unless such original issue discount is exempt from

taxation (or is subject to a reduced rate of tax) pursuant to a treaty obligation of the United States.

(B) RELATED FOREIGN PERSON.—For purposes of subparagraph (A), the term "related foreign person" means any person—

(i) who is not a United States person, and

(ii) who is related (within the meaning of section 267(b)) to the issuer.

(4) EXCEPTIONS.—This subsection shall not apply to any debt instrument described in—

(A) subparagraph (D) of section 1272(a)(2) (relating to obligations issued by natural persons before March 2, 1984), and

(B) subparagraph (E) of section 1272(a)(2) (relating to loans between natural persons).

(5) SPECIAL RULES FOR ORIGINAL ISSUE DISCOUNT ON CERTAIN HIGH YIELD OBLIGATIONS.—

(A) IN GENERAL.—In the case of an applicable high yield discount obligation issued by a corporation—

(i) no deduction shall be allowed under this chapter for the disqualified portion of the original issue discount on such obligation, and

(ii) the remainder of such original issue discount shall not be allowable as a deduction until paid.

For purposes of this paragraph, rules similar to the rules of subsection (i)(3)(B) shall apply in determining the amount of the original issue discount and when the original issue discount is paid.

(B) DISQUALIFIED PORTION TREATED AS STOCK DISTRIBUTION FOR PURPOSES OF DIVIDEND RECEIVED DEDUCTION.—

(i) IN GENERAL.—Solely for purposes of sections 243, 245, 246, and 246A, the dividend equivalent portion of any amount includible in gross income of a corporation under section 1272(a) in respect of an applicable high yield discount obligation shall be treated as a dividend

received by such corporation from the corporation issuing such obligation.

(ii) DIVIDEND EQUIVALENT PORTION.—For purposes of clause (i), the dividend equivalent portion of any amount includible in gross income under section 1272(a) in respect of an applicable high yield discount obligation is the portion of the amount so includible—

(I) which is attributable to the disqualified portion of the original issue discount on such obligation, and

(II) which would have been treated as a dividend if it had been a distribution made by the issuing corporation with respect to stock in such corporation.

(C) DISQUALIFIED PORTION.—

(i) IN GENERAL.—For purposes of this paragraph, the disqualified portion of the original issue discount on any applicable high yield discount obligation is the lesser of—

(I) the amount of such original issue discount, or

(II) the portion of the total return on such obligation which bears the same ratio to such total return as the disqualified yield on such obligation bears to the yield to maturity on such obligation.

(ii) DEFINITIONS.—For purposes of clause (i), the term "disqualified yield" means the excess of the yield to maturity on the obligation over the sum referred to subsection (i)(1)(B) plus 1 percentage point, and the term "total return" is the amount which would have been the original issue discount on the obligation if interest described in the parenthetical in section 1273(a)(2) were included in the stated redemption price at maturity.

(D) EXCEPTION FOR S CORPORATIONS.—This paragraph shall not apply to any obligation issued by any corporation for any period for which such corporation is an S corporation.

(E) EFFECT ON EARNINGS AND PROFITS.—This paragraph shall not apply for purposes of determining earnings and profits;

except that, for purposes of determining the dividend equivalent portion of any amount includible in gross income under section 1272(a) in respect of an applicable high yield discount obligation, no reduction shall be made for any amount attributable to the disqualified portion of any original issue discount on such obligation.

(F) CROSS REFERENCE.—

For definition of applicable high yield discount obligation, see subsection (i).

(6) CROSS REFERENCES.—

For provision relating to deduction of original issue discount on tax-exempt obligation, see section 1288.

For special rules in the case of the borrower under certain loans for personal use, see section 1275(b).

[Sec. 163(f)]

(f) DENIAL OF DEDUCTION FOR INTEREST ON CERTAIN OBLIGATIONS NOT IN REGISTERED FORM.—

(1) IN GENERAL.—Nothing in subsection (a) or in any other provision of law shall be

construed to provide a deduction for interest on any registration- required obligation unless such obligation is in registered form.

(2) REGISTRATION-REQUIRED OBLIGATION.—For purposes of this section—

(A) IN GENERAL.—The term "registration-required obligation" means any obligation (including any obligation issued by a governmental entity) other than an obligation which—

(i) is issued by a natural person,

(ii) is not of a type offered to the public,

(iii) has a maturity (at issue) of not more than 1 year, or

(iv) is described in subparagraph (B).

(B) CERTAIN OBLIGATIONS NOT INCLUDED.—An obligation is described in this subparagraph if—

(i) there are arrangements reasonably designed to ensure that such obligation will be sold (or resold in connection with the original issue) only to a person who is not a United States person, and

(ii) in the case of an obligation not in registered form—

(I) interest on such obligation is payable only outside the United States and its possessions, and

(II) on the face of such obligation there is a statement that any United States person who holds such obligation will be subject to limitations under the United States income tax laws.

(C) AUTHORITY TO INCLUDE OTHER OBLIGATIONS.—Clauses (ii) and (iii) of subparagraph (A), and subparagraph (B), shall not apply to any obligation if—

(i) in the case of—

(I) subparagraph (A), such obligation is of a type which the Secretary has determined by regulations to be used frequently in avoiding Federal taxes, or

(II) subparagraph (B), such obligation is of a type specified by the Secretary in regulations, and

(ii) such obligation is issued after the date on which the regulations referred to in clause (i) take effect.

(3) BOOK ENTRIES PERMITTED, ETC.—For purposes of this subsection, rules similar to the rules of section 149(a)(3) shall apply.

[Sec. 163(g)]

(g) REDUCTION OF DEDUCTION WHERE SECTION 25 CREDIT TAKEN.—The amount of the deduction under this section for interest paid or accrued during any taxable year on indebtedness with respect to which a mortgage credit certificate has been issued under section 25 shall be reduced by the amount of the credit allowable with respect to such interest under section 25 (determined without regard to section 26).

[Sec. 163(h)]

(h) DISALLOWANCE OF DEDUCTION FOR PERSONAL INTEREST.—

(1) IN GENERAL.—In the case of a taxpayer other than a corporation, no deduction shall be allowed under this chapter for personal interest paid or accrued during the taxable year.

(2) PERSONAL INTEREST.—For purposes of this subsection, the term "personal interest" means any interest allowable as a deduction under this chapter other than—

(A) interest paid or accrued on indebtedness properly allocable to a trade or business (other than the trade or business of performing services as an employee),

(B) any investment interest (within the meaning of subsection (d)),

(C) any interest which is taken into account under section 469 in computing income or loss from a passive activity of the taxpayer,

(D) any qualified residence interest (within the meaning of paragraph (3)),

(E) any interest payable under section 6601 on any unpaid portion of the tax imposed by section 2001 for the period during which an extension of time for payment of such tax is in effect under section 6163 or 6166 or under section 6166A (as in effect before its repeal by the Economic Recovery Tax Act of 1981).

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(3) QUALIFIED RESIDENCE INTEREST.—For purposes of this subsection—

(A) IN GENERAL.—The term "qualified residence interest" means any interest which is paid or accrued during the taxable year on—

(i) acquisition indebtedness with respect to any qualified residence of the taxpayer, or

(ii) home equity indebtedness with respect to any qualified residence of the taxpayer.

For purposes of the preceding sentence, the determination of whether any property is a qualified residence of the taxpayer shall be made as of the time the interest is accrued.

(B) ACQUISITION INDEBTEDNESS.—

(i) IN GENERAL.—The term "acquisition indebtedness" means any indebtedness which—

(I) is incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer, and

(II) is secured by such residence.

Such term also includes any indebtedness secured by such residence resulting from the refinancing of indebtedness meeting the requirements of the preceding sentence (or this sentence); but only to the extent the amount of the indebtedness resulting from such refinancing does not exceed the amount of the refinanced indebtedness.

(ii) $1,000,000 LIMITATION.—The aggregate amount treated as acquisition indebtedness for any period shall not exceed $1,000,000 ($500,000 in the case of a married individual filing a separate return).

(C) HOME EQUITY INDEBTEDNESS.—

(i) IN GENERAL.—The term "home equity indebtedness" means any indebtedness (other than acquisition indebtedness) secured by a qualified residence to the extent the aggregate amount of such indebtedness does not exceed—

(I) the fair market value of such qualified residence, reduced by

(II) the amount of acquisition indebtedness with respect to such residence.

(ii) LIMITATION.—The aggregate amount treated as home equity indebtedness for any period shall not exceed $100,000 ($50,000 in the case of a separate return by a married individual).

(D) Treatment of indebtedness incurred on or before October 13, 1987.—

(i) In general.—In the case of any pre-October 13, 1987, indebtedness—

(I) such indebtedness shall be treated as acquisition indebtedness, and

(II) the limitation of subparagraph (B)(ii) shall not apply.

(ii) REDUCTION IN $1,000,000 LIMITATION.—The limitation of subparagraph (B)(ii) shall be reduced (but not below zero) by the aggregate amount of outstanding pre-October 13, 1987, indebtedness.

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(iii) PRE-OCTOBER 13, 1987, INDEBTEDNESS.—The term "pre-October 13, 1987, indebtedness" means—

(I) any indebtedness which was incurred on or before October 13, 1987, and which was secured by a qualified residence on October 13, 1987, and at all times thereafter before the interest is paid or accrued, or

(II) any indebtedness which is secured by the qualified residence and was incurred after October 13, 1987, to refinance indebtedness described in subclause (I) (or refinanced indebtedness meeting the requirements of this subclause) to the extent (immediately after the refinancing) the principal amount of the indebtedness resulting from the refinancing does not exceed the principal amount of the refinanced indebtedness (immediately before the refinancing).

(iv) LIMITATION ON PERIOD OF REFINANCING.—Subclause (II) of clause (iii) shall not apply to any indebtedness after—

(I) the expiration of the term of the indebtedness described in clause (iii)(I), or

(II) if the principal of the indebtedness described in clause (iii)(I) is not amortized over its term, the expiration of the term of the 1st refinancing of such indebtedness (or if earlier, the date which is 30 years after the date of such 1st refinancing).

(4) OTHER DEFINITIONS AND SPECIAL RULES.—For purposes of this subsection—

(A) QUALIFIED RESIDENCE.—For purposes of this subsection—

(i) IN GENERAL.—The term "qualified residence" means—

(I) the principal residence (within the meaning of section 121) of the taxpayer, and

(II) 1 other residence of the taxpayer which is selected by the taxpayer for purposes of this subsection for the taxable year and which is used by the taxpayer as a residence (within the meaning of section 280A(d)(1)).

(ii) MARRIED INDIVIDUALS FILING SEPARATE RETURNS.—If a married couple does not file a joint return for the taxable year—

(I) such couple shall be treated as 1 taxpayer for purposes of clause (i), and

(II) each individual shall be entitled to take into account 1 residence unless both individuals consent in writing to 1 individual taking into account the principal residence and 1 other residence.

(iii) RESIDENCE NOT RENTED.—For purposes of clause (i)(II), notwithstanding section 280A(d)(1), if the taxpayer does not rent a dwelling unit at any time during a taxable year, such unit may be treated as a residence for such taxable year.

(B) SPECIAL RULE FOR COOPERATIVE HOUSING CORPORATIONS.—Any indebtedness secured by stock held by the taxpayer as a tenant-stockholder (as defined in section 216) in a cooperative housing corporation (as so defined) shall be treated as secured by the house or apartment which the taxpayer is entitled to occupy as such a

tenant-stockholder. If stock described in the preceding sentence may not be used to secure indebtedness, indebtedness shall be treated as so secured if the taxpayer establishes to the satisfaction of the Secretary that such indebtedness was incurred to acquire such stock.

(C) UNENFORCEABLE SECURITY INTERESTS.—Indebtedness shall not fail to be treated as secured by any property solely because, under any applicable State or local homestead or other debtor protection law in effect on August 16, 1986, the security interest is ineffective or the enforceability of the security interest is restricted.

(D) SPECIAL RULES FOR ESTATES AND TRUSTS.—For purposes of determining whether any interest paid or accrued by an estate or trust is qualified residence interest, any residence held by such estate or trust shall be treated as a qualified residence of such estate or trust if such estate or trust establishes that such residence is a qualified residence of a beneficiary who has a present interest in such estate or trust or an interest in the residuary of such estate or trust.

(5) PHASE-IN OF LIMITATION.—In the case of any taxable year beginning in calendar years 1987 through 1990, the amount of interest with

respect to which a deduction is disallowed under this subsection shall be equal to the applicable percentage (within the meaning of subsection (d)(6)(B)) of the amount which (but for this paragraph) would have been so disallowed.

[Sec. 163(i)]

(i) APPLICABLE HIGH YIELD DISCOUNT OBLIGATION.—

(1) In general.—For purposes of this section, the term "applicable high yield discount obligation" means any debt instrument if—

(A) the maturity date of such instrument is more than 5 years from the date of issue,

(B) the yield to maturity on such instrument equals or exceeds the sum of—

(i) the applicable Federal rate in effect under section 1274(d) for the calendar month in which the obligation is issued, plus

(ii) 5 percentage points, and

(C) such instrument has significant original issue discount.

For purposes of subparagraph (B)(i), the Secretary may by regulation permit a rate to be used with respect to any debt instrument which is higher than the applicable Federal rate if the taxpayer establishes to the satisfaction of the Secretary that such higher rate is based on the same principles as the applicable Federal rate and is appropriate for the term of the instrument.

(2) SIGNIFICANT ORIGINAL ISSUE DISCOUNT.—For purposes of paragraph (1)(C), a debt instrument shall be treated as having significant original issue discount if—

(A) the aggregate amount which would be includible in gross income with respect to such instrument for periods before the close of any accrual period (as defined in section 1272(a)(5)) ending after the date 5 years after the date of issue, exceeds—

(B) the sum of—

(i) the aggregate amount of interest to be paid under the instrument before the close of such accrual period, and

(ii) the product of the issue price of such instrument (as defined in sections 1273(b) and 1274(a)) and its yield to maturity.

(3) SPECIAL RULES.—For purposes of determining whether a debt instrument is an applicable high yield discount obligation—

(A) any payment under the instrument shall be assumed to be made on the last day permitted under the instrument, and

(B) any payment to be made in the form of another obligation of the issuer (or a related person within the meaning of section 453(f)(1)) shall be assumed to be made when such obligation is required to be paid in cash or in property other than such obligation.

Except for purposes of paragraph (1)(B), any reference to an obligation in subparagraph (B) of this paragraph shall be treated as including a reference to stock.

(4) DEBT INSTRUMENT.—For purposes of this subsection, the term "debt instrument" means any instrument which is a debt instrument as defined in section 1275(a).

(5) REGULATIONS.—The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this subsection and subsection (e)(5), including—

(A) regulations providing for modifications to the provisions of this subsection and subsection (e)(5) in the case of varying rates of interest, put or call options, indefinite maturities, contingent payments, assumptions of debt instruments, conversion rights, or other circumstances where such modifications are appropriate to carry out the purposes of this subsection and subsection (e)(5), and

(B) regulations to prevent avoidance of the purposes of this subsection and subsection (e)(5) through the use of issuers other than C corporations, agreements to borrow amounts due under the debt instrument, or other arrangements.

[Sec. 163(j)]

(j) LIMITATION ON DEDUCTION FOR INTEREST ON CERTAIN INDEBTEDNESS.—

(1) LIMITATION.—

(A) IN GENERAL.—If this subsection applies to any corporation for any taxable year, no deduction shall be allowed under

this chapter for disqualified interest paid or accrued by such corporation during such taxable year. The amount disallowed under the preceding sentence shall not exceed the corporation's excess interest expense for the taxable year.

(B) DISALLOWED AMOUNT CARRIED TO SUCCEEDING TAXABLE YEAR.—Any amount disallowed under subparagraph (A) for any taxable year shall be treated as disqualified interest paid or accrued in the succeeding taxable year (and clause (ii) of paragraph (2)(A) shall not apply for purposes of applying this subsection to the amount so treated).

(2) CORPORATIONS TO WHICH SUBSECTION APPLIES.—

(A) IN GENERAL.—This subsection shall apply to any corporation for any taxable year if—

(i) such corporation has excess interest expense for such taxable year, and

(ii) the ratio of debt to equity of such corporation as of the close of such taxable year (or on any other day during the taxable year as the Secretary may

by regulations prescribe) exceeds 1.5 to 1.

(B) EXCESS INTEREST EXPENSE.—

(i) IN GENERAL.—For purposes of this subsection, the term "excess interest expense" means the excess (if any) of—

(I) the corporation's net interest expense, over

(II) the sum of 50 percent of the adjusted taxable income of the corporation plus any excess limitation carryforward under clause (ii).

(ii) EXCESS LIMITATION CARRYFORWARD.—If a corporation has an excess limitation for any taxable year, the amount of such excess limitation shall be an excess limitation carryforward to the 1st succeeding taxable year and to the 2nd and 3rd succeeding taxable years to the extent not previously taken into account under this clause. The amount of such a carryforward taken into account for any such succeeding taxable year shall not exceed the excess interest expense for

such succeeding taxable year (determined without regard to the carryforward from the taxable year of such excess limitation).

(iii) EXCESS LIMITATION.—For purposes of clause (ii), the term "excess limitation" means the excess (if any) of—

(I) 50 percent of the adjusted taxable income of the corporation, over

(II) the corporation's net interest expense.

(C) RATIO OF DEBT TO EQUITY.—For purposes of this paragraph, the term "ratio of debt to equity" means the ratio which the total indebtedness of the corporation bears to the sum of its money and all other assets reduced (but not below zero) by such total indebtedness. For purposes of the preceding sentence—

(i) the amount taken into account with respect to any asset shall be the adjusted basis thereof for purposes of determining gain,

(ii) the amount taken into account with respect to any indebtedness with original issue discount shall be its issue price plus the portion of the original issue discount previously accrued as determined under the rules of section 1272 (determined without regard to subsection (a)(7) or (b)(4) thereof), and

(iii) here shall be such other adjustments as the Secretary may by regulations prescribe.

(3) DISQUALIFIED INTEREST.—For purposes of this subsection, the term "disqualified interest" means—

(A) any interest paid or accrued by the taxpayer (directly or indirectly) to a related person if no tax is imposed by this subtitle with respect to such interest,

(B) any interest paid or accrued by the taxpayer with respect to any indebtedness to a person who is not a related person if—

(i) there is a disqualified guarantee of such indebtedness, and

(ii) no gross basis tax is imposed by this subtitle with respect to such interest.

(4) RELATED PERSON.—For purposes of this subsection—

(A) IN GENERAL.—Except as provided in subparagraph (B), the term "related person" means any person who is related (within the meaning of section 267(b) or 707(b)(1)) to the taxpayer.

(B) SPECIAL RULE FOR CERTAIN PARTNERSHIPS.—

(i) IN GENERAL.—Any interest paid or accrued to a partnership which (without regard to this subparagraph) is a related person shall not be treated as paid or accrued to a related person if less than 10 percent of the profits and capital interests in such partnership are held by persons with respect to whom no tax is imposed by this subtitle on such interest. The preceding sentence shall not apply to any interest allocable to any partner in such partnership who is a related person to the taxpayer.

(ii) SPECIAL RULE WHERE TREATY REDUCTION.—If any treaty between the United States and any foreign country reduces the rate of tax imposed by this subtitle on a partner's share of any interest paid or accrued to a partnership,

such partner's interests in such partnership shall, for purposes of clause (i), be treated as held in part by a tax-exempt person and in part by a taxable person under rules similar to the rules of paragraph (5)(B).

(5) SPECIAL RULES FOR DETERMINING WHETHER INTEREST IS SUBJECT TO TAX.—

(A) TREATMENT OF PASS-THRU ENTITIES.—In the case of any interest paid or accrued to a partnership, the determination of whether any tax is imposed by this subtitle on such interest shall be made at the partner level. Rules similar to the rules of the preceding sentence shall apply in the case of any pass-thru entity other than a partnership and in the case of tiered partnerships and other entities.

(B) INTEREST TREATED AS TAX-EXEMPT TO EXTENT OF TREATY REDUCTION.—If any treaty between the United States and any foreign country reduces the rate of tax imposed by this subtitle on any interest paid or accrued by the taxpayer, such interest shall be treated as interest on which no tax is imposed by this subtitle to the extent of the same proportion of such interest as—

(i) the rate of tax imposed without regard to such treaty, reduced by the rate of tax imposed under the treaty, bears to

(ii) the rate of tax imposed without regard to the treaty.

(6) OTHER DEFINITIONS AND SPECIAL RULES.—For purposes of this subsection—

(A) ADJUSTED TAXABLE INCOME.—The term "adjusted taxable income" means the taxable income of the taxpayer—

(i) computed without regard to—

(I) any deduction allowable under this chapter for the net interest expense.

(II) the amount of any net operating loss deduction under section 172, and

(III) any deduction allowable for depreciation, amortization, or depletion, and

(ii) computed with such other adjustments as the Secretary may by regulations prescribe.

(B) NET INTEREST EXPENSE.—The term "net interest expense" means the excess (if any) of—

(i) the interest paid or accrued by the taxpayer during the taxable year, over

(ii) the amount of interest includible in the gross income of such taxpayer for such taxable year.

The Secretary may by regulations provide for adjustments in determining the amount of net interest expense.

(C) TREATMENT OF AFFILIATED GROUP.—All members of the same affiliated group (within the meaning of section 1504(a)) shall be treated as 1 taxpayer.

(D) DISQUALIFIED GUARANTEE.—

(i) IN GENERAL.—Except as provided in clause (ii), the term "disqualified guarantee" means any guarantee by a related person which is—

(I) an organization exempt from taxation under this subtitle, or

(II) a foreign person.

(ii) EXCEPTIONS.—The term "disqualified guarantee" shall not include a guarantee—

(I) in any circumstances identified by the Secretary by regulation, where the interest on the indebtedness would have been subject to a net basis tax if the interest had been paid to the guarantor, or

(II) if the taxpayer owns a controlling interest in the guarantor.

For purposes of subclause (II), except as provided in regulations, the term "a controlling interest" means direct or indirect ownership of at least 80 percent of the total voting power and value of all classes of stock of a corporation, or 80 percent of the profit and capital interests in any other entity. For purposes of the preceding sentence, the rules of paragraphs (1) and (5) of section 267(c) shall apply; except that such rules shall also apply to interest in entities other than corporations.

(iii) GUARANTEE.—Except as provided in regulations, the term "guarantee" includes any arrangement under which a person (directly or indirectly through an entity or otherwise) assures, on a conditional or unconditional basis, the payment of another person's obligation under any indebtedness.

(E) GROSS BASIS AND NET BASIS TAXATION.—

(i) GROSS BASIS TAX.—The term "gross basis tax" means any tax imposed by this subtitle which is determined by reference to the gross amount of any item of income without any reduction for any deduction allowed by this subtitle.

(ii) NET BASIS TAX.—The term "net basis tax" means any tax imposed by this subtitle which is not a gross basis tax.

(7) COORDINATION WITH PASSIVE LOSS RULES, ETC.—This subsection shall be applied before sections 465 and 469.

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(8) REGULATIONS.—The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this subsection, including—

(A) such regulations as may be appropriate to prevent the avoidance of the purposes of this subsection,

(B) regulations providing such adjustments in the case of corporations which are members of an affiliated group as may be appropriate to carry out the purposes of this subsection, and

(C) regulations for the coordination of this subsection with section 884.

[Sec. 163(k)]

(k) CROSS REFERENCES.—

(1) For disallowance of certain amounts paid in connection with insurance, endowment, or annuity contracts, see section 264.

(2) For disallowance of deduction for interest relating to tax-exempt income, see section 265(a)(2).

(3) For disallowance of deduction for carrying charges chargeable to capital account, see section 266.

(4) For disallowance of interest with respect to transactions between related taxpayers, see section 267.

(5) For treatment of redeemable ground rents and real property held subject to liabilities under redeemable ground rents, see section 1055.

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26 U.S.C. § 264

SEC. 264. CERTAIN AMOUNTS PAID IN CONNECTION WITH INSURANCE CONTRACTS.

[Sec. 264(a)]

(a) GENERAL RULE.—No deduction shall be allowed for—

(1) Premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business ~~carried on~~ by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy.

(2) Any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract.

(3) Except as provided in subsection (c), any amount paid or accrued on indebtedness incurred or continued to purchase or carry a life insurance, endowment, or annuity contract (other than a single premium contract or a contract treated as a single premium contract) pursuant to a plan of purchase which contemplates the systematic direct or indirect borrowing of part or all of the increases in the

cash value of such contract (either from the insurer or otherwise).

(4) Except as provided in subsection (d), any interest paid or accrued on any indebtedness with respect to 1 or more life insurance policies owned by the taxpayer covering the life of any individual, or any endowment or annuity contracts owned by the taxpayer covering any individual, who—

(A) is an officer or employee of, or

(B) is financially interested in,

any trade or business carried on by the taxpayer.

Paragraph (2) shall apply in respect of annuity contracts only as to contracts purchased after March 1, 1954. Paragraph (3) shall apply only in respect of contracts purchased after August 6, 1963. Paragraph (4) shall apply with respect to contracts purchased after June 20, 1986.

[Sec. 264(b)]

(b) CONTRACTS TREATED AS SINGLE PREMIUM CONTRACTS.—For purposes of subsection (a) (2), a contract shall be treated as a single premium contract—

(1) if substantially all the premiums on the contract are paid within a period of 4 years. from the date on which the contract is purchased, or

(2) if an amount is deposited after March 1, 1954, with the insurer for payment of a substantial number of future premiums on the contract.

[Sec. 264(c)]

(c) EXCEPTIONS.—Subsection (a)(3) shall not apply to any amount paid or accrued by a person during a taxable year on indebtedness incurred or continued as part of a plan referred to in subsection (a)(3)—

(1) if no part of 4 of the annual premiums due during the 7-year period (beginning with the date the first premium on the contract to which such plan relates was paid) is paid under such plan by means of indebtedness,

(2) if the total of the amounts paid or accrued by such person during such taxable year for which (without regard to this paragraph) no deduction would be allowable by reason of subsection (ax3) does not exceed $100,

(3) if such amount was paid or accrued on indebtedness incurred because of an unforeseen

substantial loss of income or unforeseen substantial increase in his financial obligations, or

(4) if such indebtedness was incurred in connection with his trade or business.

For purposes of applying paragraph (1), if there is a substantial increase in the premiums on a contract, a new 7-year period described in such paragraph with respect to such contract shall commence on the date the first such increased premium is paid.

Amendments

P.L. 88-272, § 215(b):

Amended section 264 to add subsection (c) above. The amendment applies with respect to amounts paid or accrued in taxable years beginning after December 31, 1963.

[Sec. 264(d)]

(d) SPECIAL RULES FOR APPLICATION OF SUBSECTION (a)(4).—

(1) EXCEPTION FOR KEY PERSONS.—Subsection (a)(4) shall not apply to any interest paid or accrued on any indebtedness with respect to policies or contracts covering an

individual who is a key person to the extent that the aggregate amount of such indebtedness with respect to policies and contracts covering such individual does not exceed $50,000.

(2) INTEREST RATE CAP ON KEY PERSONS AND PRE-1986 CONTRACTS.—

(A) IN GENERAL.—No deduction shall be allowed by reason of paragraph (1) or the last sentence of subsection (a) with respect to interest paid or accrued for any month beginning after December 31, 1995, to the extent the amount of such interest exceeds the amount which would have been determined if the applicable rate of interest were used for such month.

(B) APPLICABLE RATE OF INTEREST.—For purposes of subparagraph (A)—

(i) IN GENERAL.—The applicable rate of interest for any month is the rate of interest described as Moody's Corporate Bond Yield Average-Monthly Average Corporates as published by Moody's Investors Service, Inc., or any successor thereto, for such month.

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(ii) PRE-1986 CONTRACTS.—In the case of indebtedness on a contract purchased on or before June 20, 1986—

(I) which is a contract providing a fixed rate of interest, the applicable rate of interest for any month shall be the Moody's rate described in clause (i) for the month in which the contract was purchased, or

(II) which is a contract providing a variable rate of interest, the applicable rate of interest for any month in an applicable period shall be such Moody's rate for the third month preceding the first month in such period.

For purposes of subclause (II), the taxpayer shall elect an applicable period for such contract on its return of tax imposed by this chapter for its first taxable year ending on or after October 13, 1995. Such applicable period shall be for any number of months (not greater than 12) specified in the election and may not be changed by the taxpayer without the consent of the Secretary.

(3) KEY PERSON.—For purposes of paragraph (1), the term "key person" means an officer or 20-percent owner, except that the number of individuals who may be treated as key persons with respect to any taxpayer shall not exceed the greater of—

(A) 5 individuals, or

(B) the lesser of 5 percent of the total officers and employees of the taxpayer or 20 individuals.

(4) 20-PERCENT OWNER.—For purposes of this subsection, the term "20-percent owner" means—

(A) if the taxpayer is a corporation, any person who owns directly 20 percent or more of the outstanding stock of the corporation or stock possessing 20 percent or more of the total combined voting power of all stock of the corporation, or

(B) if the taxpayer is not a corporation, any person who owns 20 percent or more of the capital or profits interest in the taxpayer.

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(5) AGGREGATION RULES.—

(A) IN GENERAL.—For purposes of paragraph (4)(A) and applying the $50,000 limitation in paragraph (1)—

(i) all members of a controlled group shall be treated as 1 taxpayer, and

(ii) such limitation shall be allocated among the members of such group in such manner as the Secretary may prescribe.

(B) CONTROLLED GROUP.—For purposes of this paragraph, all persons treated as a single employer under subsection (a) or (b) of section 52 or subsection (m) or (o) of section 414 shall be treated as members of a controlled group.

Appendix D

26 U.S.C. § 7702

SEC. 7702. LIFE INSURANCE CONTRACT DEFINED

[Sec. 7702(a)]

(a) GENERAL RULE.—For purposes of this title, the term "life insurance contract" means any contract which is a life insurance contract under the applicable law, but only if such contract—

(1) meets the cash value accumulation test of subsection (b), or

(2)(A) meets the guideline premium requirements of subsection (c), and

(B) falls within the cash value corridor of subsection (d).

[Sec. 7702(b)]

(b) CASH VALUE ACCUMULATION TEST FOR SUBSECTION (a)(1).—

(1) IN GENERAL.—A contract meets the cash value accumulation test of this subsection if, by the terms of the contract, the cash surrender value of such contract may not at any time exceed the net single premium which would have to be paid at such time to fund future benefits under the contract.

(2) RULES FOR APPLYING PARAGRAPH (1).—Determinations under paragraph (1) shall be made—

(A) on the basis of interest at the greater of an annual effective rate of 4 percent or the rate or rates guaranteed on issuance of the contract,

(B) on the basis of the rules of subparagraph (B)(i) (and, in the case of qualified additional benefits, subparagraph (B)(ii)) of subsection (c)(3), and

(C) by taking into account under subparagraphs (A) and (D) of subsection (e)(1) only current and future death benefits and qualified additional benefits.

[Sec. 7702(c)]

(c) GUIDELINE PREMIUM REQUIREMINTS.—For purposes of this section—

(1) IN GENERAL.—A contract meets the guideline premium requirements of this subsection if the sum of the premiums paid under such contract does not at any time exceed the guideline premium limitation as of such time.

(2) GUIDELINE PREMIUM LIMITATION.—The term "guideline premium limitation" means, as of any date, the greater of—

(A) the guideline single premium, or

(B) the sum of the guideline level premiums to such date.

(3) GUIDELINE SINGLE PREMIUM.—

(A) IN GENERAL.—The term "guideline single premium" means the premium at issue with respect to future benefits under the contract.

(B) BASIS ON WHICH DETERMINATION IS MADE.—The determination under subparagraph (A) shall be based on—

(i) reasonable mortality charges which meet the requirements (if any) prescribed in regulations and which (except as provided in regulations) do not exceed the mortality charges specified in the prevailing commissioners' standard tables (as defined in section 807(d)(5)) as of the time the contract is issued,

(ii) any reasonable charges (other than mortality charges) which (on the

basis of the company's experience, if any, with respect to similar contracts) are reasonably expected to be actually paid, and

(iii) interest at the greater of an annual effective rate of 6 percent or the rate or rates guaranteed on issuance of the contract.

(C) WHEN DETERMINATION MADE.—Except as provided in subsection (f)(7), the determination under subparagraph (A) shall be made as of the time the contract is issued.

(D) SPECIAL RULES FOR SUBPARAGRAPH (B)(ii).—

(i) CHARGES NOT SPECIFIED IN THE CONTRACT.—If any charge is not specified in the contract, the amount taken into account under subparagraph (B)(ii) for such charge shall be zero.

(ii) NEW COMPANIES, ETC.—If any company does not have adequate experience for purposes of the determination under subparagraph (B)(ii), to the extent provided in regulations, such determination shall be made on the basis of the industry-wide experience.

(4) GUIDELINE LEVEL PREMIUM.—The term "guideline level premium" means the level annual amount, payable over a period not ending before the insured attains age 95, computed on the same basis as the guideline single premium, except that paragraph (3)(B)(iii) shall be applied by substituting "4 percent" for "6 percent".

[Sec. 7702(d)]

(d) CASH VALUE CORRIDOR FOR PURPOSES OF SUBSECTION (a)(2)(B).—For purposes of this section—

(1) IN GENERAL.—A contract falls within the cash value corridor of this subsection if the death benefit under the contract at any time is not less than the applicable percentage of the cash surrender value.

(2) APPLICABLE PERCENTAGE.—

In the case of an insured with an attained age as of the beginning of the contract year of:		The applicable percentage shall decrease by a ratable portion for each full year:	
More than:	But not more than:	From:	To:
0	40	250	250
40	45	250	215
45	50	215	185
50	55	185	150
55	60	150	130
60	65	130	120
65	70	120	115
70	75	115	105
75	90	105	105
90	95	105	100

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[Sec. 7702(e)]

(e) COMPUTATIONAL RULES.—

(1) IN GENERAL.—For purposes of this section (other than subsection (d))—

(A) the death benefit (and any qualified additional benefit) shall be deemed not to increase,

(B) the maturity date, including the date on which any benefit described in subparagraph (C) is payable, shall be deemed to be no earlier than the day on which the insured attains age 95, and no later than the day on which the insured attains age 100,

(C) the death benefits shall be deemed to be provided until the maturity date determined by taking into account subparagraph (B), and

(D) the amount of any endowment benefit (or sum of endowment benefits, including any cash surrender value on the maturity date determined by taking into account subparagraph (B)) shall be deemed not to exceed the least amount payable as a death benefit at any time under the contract.

(2) LIMITED INCREASES IN DEATH BENEFIT PERMITTED.—Notwithstanding paragraph (1)(A)—

(A) for purposes of computing the guideline level premium, an increase in the death benefit which is provided in the contract may be taken into account but only to the extent necessary to prevent a decrease in the excess of the death benefit over the cash surrender value of the contract,

(B) for purposes of the cash value accumulation test, the increase described in subparagraph (A) may be taken into account if the contract will meet such test at all times assuming that the net level reserve (determined as if level annual premiums were paid for the contract over a period not ending before the insured attains age 95) is substituted for the net single premium, and

(C) for purposes of the cash value accumulation test, the death benefit increases may be taken into account if the contract—

(i) has an initial death benefit of $5,000 or less and a maximum death benefit of $25,000 or less,

(ii) provides for a fixed predetermined annual increase not to exceed 10 percent of the initial death benefit or 8 percent of the death benefit at the end of the preceding year, and

(iii) was purchased to cover payment of burial expenses or in connection with prearranged funeral expenses.

For purposes of subparagraph (C), the initial death benefit of a contract shall be determined by treating all contracts issued to the same contract owner as 1 contract.

[Sec. 7702(f)]

(f) OTHER DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

(1) PREMIUMS PAID.—

(A) IN GENERAL.—The term "premiums paid" means the premiums paid under the contract less amounts (other than amounts includible in gross income) to which section 72(e) applies and less any excess premiums with respect to which there is a distribution

described in subparagraph (B) or (E) of paragraph (7) and any other amounts received with respect to the contract which are specified in regulations.

(B) TREATMENT OF CERTAIN PREMIUMS RETURNED TO POLICYHOLDER.—If, in order to comply with the requirements of subsection (a)(2)(A), any portion of any premium paid during any contract year is returned by the insurance company (with interest) within 60 days after the end of a contract year, the amount so returned (excluding interest) shall be deemed to reduce the sum of the premiums paid under the contract during such year.

(C) INTEREST RETURNED INCLUDIBLE IN GROSS INCOME.—Notwithstanding the provisions of section 72(e), the amount of any interest returned as provided in subparagraph (B) shall be includible in the gross income of the recipient.

(2) CASH VALUES.—

(A) CASH SURRENDER VALUE.—The cash surrender value of any contract shall be its cash value determined without regard to any surrender charge, policy loan, or reasonable termination dividends.

(B) NET SURRENDER VALUE.—The net surrender value of any contract shall be determined with regard to surrender charges but without regard to any policy loan.

(3) DEATH BENEFIT.—The term "death benefit" means the amount payable by reason of the death of the insured (determined without regard to any qualified additional benefits).

(4) FUTURE BENEFITS.—The term "future benefits" means death benefits and endowment benefits.

(5) QUALIFIED ADDITIONAL BENEFITS.—

(A) IN GENERAL.—The term "qualified additional benefits" means any—

(i) guaranteed insurability,

(ii) accidental death or disability benefit,

(iii) family term coverage,

(iv) disability waiver benefit, or

(v) other benefit prescribed under regulations.

(B) TREATMENT OF QUALIFIED ADDITIONAL BENEFITS.—For purposes of this section, qualified additional benefits shall not be treated as future benefits under the contract, but the charges for such benefits shall be treated as future benefits.

(C) TREATMENT OF OTHER ADDITIONAL BENEFITS.—In the case of any additional benefit which is not a qualified additional benefit—

(i) such benefit shall not be treated as a future benefit, and

(ii) any charge for such benefit which is not prefunded shall not be treated as a premium.

(6) PREMIUM PAYMENTS NOT DISQUALIFYING CONTRACT.—The payment of a premium which would result in the sum of the premiums paid exceeding the guideline premium limitation shall be disregarded for purposes of subsection (a)(2) if the amount of such premium does not exceed the amount necessary to prevent the termination of the contract on or before the end of the contract year (but only if the contract will have no cash surrender value at the end of such extension period).

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(7) ADJUSTMENTS.—

(A) IN GENERAL.—If there is a change in the benefits under (or in other terms of) the contract which was not reflected in any previous determination or adjustment made under this section, there shall be proper adjustments in future determinations made under this section.

(B) RULE FOR CERTAIN CHANGES DURING FIRST 15 YEARS.—If—

(i) a change described in subparagraph (A) reduces benefits under the contract,

(ii) the change occurs during the 15-year period beginning on the issue date of the contract, and

(iii) a cash distribution is made to the policyholder as a result of such change,

section 72 (other than subsection (e)(5) thereof) shall apply to such cash distribution to the extent it does not exceed the recapture ceiling determined under subparagraph (C) or (D) (whichever applies).

(C) RECAPTURE CEILING WHERE CHANGE OCCURS DURING FIRST 5 YEARS.—If the change referred to in subparagraph (B)(ii) occurs during the 5-year period beginning on the issue date of the contract, the recapture ceiling is—

(i) in the case of a contract to which subsection (a)(1) applies, the excess of—

(I) the cash surrender value of the contract, immediately before the reduction, over

(II) the net single premium (determined under subsection (b)), immediately after the reduction, or

(ii) in the case of a contract to which subsection (a)(2) applies, the greater of—

(I) the excess of the aggregate premiums paid under the contract, immediately before the reduction, over the guideline premium limitation for the contract (determined under subsection (c)(2), taking into account the adjustment described in subparagraph (A)), or

(II) the excess of the cash surrender value of the contract, immediately before the reduction, over the cash value corridor of subsection (d) (determined immediately after the reduction).

(D) RECAPTURE CEILING WHERE CHANGE OCCURS AFTER 5TH YEAR AND BEFORE 16TH YEAR.—If the change referred to in subparagraph (B) occurs after the 5-year period referred to under subparagraph (C), the recapture ceiling is the excess of the cash surrender value of the contract, immediately before the reduction, over the cash value corridor of subsection (d) (determined immediately after the reduction and whether or not subsection (d) applies to the contract).

(E) TREATMENT OF CERTAIN DISTRIBUTIONS MADE IN ANTICIPATION OF BENEFIT REDUCTIONS.—Under regulations prescribed by the Secretary, subparagraph (B) shall apply also to any distribution made in anticipation of a reduction in benefits under the contract. For purposes of the preceding sentence, appropriate adjustments shall be made in the provisions of subparagraphs (C) and (D); and any distribution which reduces the cash surrender value of a contract and which is made within 2 years

before a reduction in benefits under the contract shall be treated as made in anticipation of such reduction.

(8) CORRECTION OF ERRORS.—If the taxpayer establishes to the satisfaction of the Secretary that—

(A) the requirements described in subsection (a) for any contract year were not satisfied due to reasonable error, and

(B) reasonable steps are being taken to remedy the error,

the Secretary may waive the failure to satisfy such requirements.

(9) SPECIAL RULE FOR VARIABLE LIFE INSURANCE CONTRACTS.—In the case of any contract which is a variable contract (as defined in section 817), the determination of whether such contract meets the requirements of subsection (a) shall be made whenever the death benefits under such contract change but not less frequently than once during each 12-month period.

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[Sec. 7702(g)]

(g) TREATMENT OF CONTRACTS WHICH DO NOT MEET SUBSECTION (A) TEST.—

(1) INCOME INCLUSION.—

(A) IN GENERAL.—If at any time any contract which is a life insurance contract under the applicable law does not meet the definition of life insurance contract under subsection (a), the income on the contract for any taxable year of the policyholder shall be treated as ordinary income received or accrued by the policyholder during such year.

(B) INCOME ON THE CONTRACT.—For purposes of this paragraph, the term "income on the contract" means, with respect to any taxable year of the policyholder, the excess of—

(i) the sum of—

(I) the increase in the net surrender value of the contract during the taxable year, and

(II) the cost of life insurance protection provided under the contract during the taxable year, over

(ii) the premiums paid (as defined in subsection (f)(1)) under the contract during the taxable year.

(C) CONTRACTS WHICH CEASE TO MEET DEFINITION.—If, during any taxable year of the policyholder, a contract which is a life insurance contract under the applicable law ceases to meet the definition of life insurance contract under subsection (a), the income on the contract for all prior taxable years shall be treated as received or accrued during the taxable year in which such cessation occurs.

(D) COST OF LIFE INSURANCE PROTECTION.—For purposes of this paragraph, the cost of life insurance protection provided under the contract shall be the lesser of—

(i) the cost of individual insurance on the life of the insured as determined on the basis of uniform premiums (computed on the basis of 5-year age brackets) prescribed by the Secretary by regulations, or

(ii) the mortality charge (if any) stated in the contract.

(2) TREATMENT OF AMOUNT PAID ON DEATH OF INSURED.—If any contract which is a life insurance contract under the applicable law does not meet the definition of life insurance contract under subsection (a), the excess of the amount paid by the reason of the death of the insured over the net surrender value of the contract shall be deemed to be paid under a life insurance contract for purposes of section 101 and subtitle B.

(3) CONTRACT CONTINUES TO BE TREATED AS INSURANCE CONTRACT.—If any contract which is a life insurance contract under the applicable law does not meet the definition of life insurance contract under subsection (a), such contract shall, notwithstanding such failure, be treated as an insurance contract for purposes of this title.

[Sec. 7702(h)]

(h) ENDOWMENT CONTRACTS RECEIVE SAME TREATMENT.—

(1) IN GENERAL.—References in subsections (a) and (g) to a life insurance contract shall be treated as including references to a contract which is an endowment contract under the applicable law.

(2) DEFINITION OF ENDOWMENT CONTRACT.—For purposes of this title (other than paragraph (1)), the term "endowment contract" means a contract which is an endowment contract under the applicable law and which meets the requirements of subsection (a).

[Sec. 7702(i)]

(i) TRANSITIONAL RULE FOR CERTAIN 20-PAY CONTRACTS.—

(1) IN GENERAL.—In the case of a qualified 20-pay contract, this section shall be applied by substituting "3 percent" for "4 percent" in subsection (b)(2).

(2) QUALIFIED 20-PAY CONTRACT.—For purposes of paragraph (1), the term "qualified 20-pay contract" means any contract which—

(A) requires at least 20 nondecreasing annual premium payments, and

(B) is issued pursuant to an existing plan of insurance.

(3) EXISTING PLAN OF INSURANCE.—For purposes of this subsection, the term "existing plan of insurance" means, with respect to any contract, any plan of insurance which was filed by the company issuing such contract in 1 or

more States before September 28, 1983, and is on file in the appropriate State for such contract.

[Sec. 7702(j)]

(j) CERTAIN CHURCH SELF FUNDED DEATH BENEFIT PLANS TREATED AS LIFE INSURANCE.—

(1) IN GENERAL.—In determining whether any plan or arrangement described in paragraph (2) is a life insurance contract, the requirement of subsection (a) that the contract be a life insurance contract under applicable law shall not apply.

(2) DESCRIPTION.—For purposes of this subsection, a plan or arrangement is described in this paragraph if—

(A) such plan or arrangement provides for the payment of benefits by reason of the death of the individuals covered under such plan or arrangement, and

(B) such plan or arrangement is provided by a church for the benefit of its employees and their beneficiaries, directly or through an organization described in section 414(e)(3)(A) or an organization described in section 414(e)(3)(B)(ii).

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(3) DEFINITIONS.—For purposes of this subsection—

(A) CHURCH.—The term "church" means a church or a convention or association of churches.

(B) EMPLOYEE.—The term "employee" includes an employee described in section 414(e)(3)(B).

Appendix D

26 U.S.C. § 7702A

SEC. 7702A. MODIFIED ENDOWMENT CONTRACT DEFINED.

[Sec. 7702A(a)]

(a) GENERAL RULE.—For purposes of section 72, the term "modified endowment contract" means any contract meeting the requirements of section 7702—

(1) which—

(A) is entered into on or after June 21, 1988, and

(B) fails to meet the 7-pay test of subsection (b), or

(2) which is received in exchange for a contract described in paragraph (1).

[Sec. 7702A(b)]

(b) 7-PAY TEST.—For purposes of subsection (a), a contract fails to meet the 7-pay test of this subsection if the accumulated amount paid under the contract at any time during the 1st 7 contract years exceeds the sum of the net level premiums which would have been paid on or before such

time if the contract provided for paid-up future benefits after the payment of 7 level annual premiums.

[Sec. 7702A(c)]

(c) COMPUTATIONAL RULES.—

(1) IN GENERAL.—Except as provided in this subsection, the determination under subsection (b) of the 7 level annual premiums shall be made—

(A) as of the time the contract is issued, and

(B) by applying the rules of section 7702(b)(2) and of section 7702(e) (other than paragraph (2)(C) thereof), except that the death benefit provided for the 1st contract year shall be deemed to be provided until the maturity date without regard to any scheduled reduction after the 1st 7 contract years.

(2) REDUCTION IN BENEFITS DURING 1ST 7 YEARS.—

(A) IN GENERAL.—If there is a reduction in benefits under the contract within the 1st 7 contract years, this section shall be

applied as if the contract had originally been issued at the reduced benefit level.

(B) REDUCTIONS ATTRIBUTABLE TO NONPAYMENT OF PREMIUMS.—Any reduction in benefits attributable to the nonpayment of premiums due under the contract shall not be taken into account under subparagraph (A) if the benefits are reinstated within 90 days after the reduction in such benefits.

(3) TREATMENT OF MATERIAL CHANGES.—

(A) IN GENERAL.—If there is a material change in the benefits under (or in other terms of) the contract which was not reflected in any previous determination under this section, for purposes of this section—

(i) such contract shall be treated as a new contract entered into on the day on which such material change takes effect, and

(ii) appropriate adjustments shall be made in determining whether such contract meets the 7-pay test of subsection (b) to take into account the cash surrender value under the contract.

(B) TREATMENT OF CERTAIN BENEFIT INCREASES.—For purposes of subparagraph (A), the term "material change" includes any increase in the death benefit under the contract or any increase in, or addition of, a qualified additional benefit under the contract. Such term shall not include—

(i) any increase which is attributable to the payment of premiums necessary to fund the lowest level of the death benefit and qualified additional benefits payable in the 1st 7 contract years (determined after taking into account death benefit increases described in subparagraph (A) or (B) of section 7702(e)(2)) or to crediting of interest or other earnings (including policyholder dividends) in respect of such premiums, and

(ii) to the extent provided in regulations, any cost-of-living increase based on an established broad-based index if such increase is funded ratably over the remaining period during which premiums are required to be paid under the contract.

(4) SPECIAL RULE FOR CONTRACTS WITH DEATH BENEFITS OF $10,000 OR LESS.—In the case of a contract—

(A) which provides an initial death benefit of $10,000 or less, and

(B) which requires at least 7 non-decreasing annual premium payments,

each of the 7 level annual premiums determined under subsection (b) (without regard to this paragraph) shall be increased by $75. For purposes of this paragraph, the contract involved and all contracts previously issued to the same policyholder by the same company shall be treated as one contract.

(5) REGULATORY AUTHORITY FOR CERTAIN COLLECTION EXPENSES.—The Secretary may by regulations prescribe rules for taking into account expenses solely attributable to the collection of premiums paid more frequently than annually.

(6) TREATMENT OF CERTAIN CONTRACTS WITH MORE THAN ONE INSURED.—If—

(A) a contract provides a death benefit which is payable only upon the death of 1 insured following (or occurring simultaneously with) the death of another insured, and

(B) there is a reduction in such death benefit below the lowest level of such death benefit provided under the contract during the 1st 7 contract years, this section shall be applied as if the contract had originally been issued at the reduced benefit level.

[Sec. 7702A(d)]

(d) DISTRIBUTIONS AFFECTED.--If a contract fails to meet the 7-pay test of subsection (b), such contract shall be treated as failing to meet such requirements only in the case of—

(1) distributions during the contract year in which the failure takes effect and during any subsequent contract year, and

(2) under regulations prescribed by the Secretary, distributions (not described in paragraph (1)) in anticipation of such failure.

For purposes of the preceding sentence, any distribution which is made within 2 years before the failure to meet the 7-pay test shall be treated as made in anticipation of such failure.

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[Sec. 7702A(e)]

(e) DEFINITIONS.—For purposes of this section—

(1) AMOUNT PAID.—

(A) IN GENERAL.—The term "amount paid" means—

(i) the premiums paid under the contract, reduced by

(ii) amounts to which section 72(e) applies (determined without regard to paragraph (4)(A) thereof) but not including amounts includible in gross income.

(B) TREATMENT OF CERTAIN PREMIUMS RETURNED.—If, in order to comply with the requirements of subsection (b), any portion of any premium paid during any contract year is returned by the insurance company (with interest) within 60 days after the end of such contract year, the amount so returned (excluding interest) shall be deemed to reduce the sum of the premiums paid under the contract during such contract year.

(C) INTEREST RETURNED INCLUDIBLE IN GROSS INCOME.—Notwithstanding the provisions of section 72(e), the amount of any interest returned as provided in subparagraph (B) shall be includible in the gross income of the recipient.

(2) CONTRACT YEAR.—The term "contract year" means the 12-month period beginning with the 1st month for which the contract is in effect, and each 12-month period beginning with the corresponding month in subsequent calendar years.

(3) OTHER TERMS.—Except as otherwise provided in this section, terms used in this section shall have the same meaning as when used in section 7702.